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# Supreme Court of the United States

OCTOBER TERM, 1948.

No. 442.

HANNAH COHEN, Executrix of the Estate of Sol Cohen, deceased, and DAVID F. COHEN, Intervenor,
Petitioners,

*against*

BENEFICIAL INDUSTRIAL LOAN CORPORATION,
Respondent,

*and*

O. W. CASPERSON, JOHN BUDD SMITH, ROY E. TUCKER, EVERETT T. FELTER, JACKSON R. COLLINS, C. V. SMITH, E. L. KINCAID, ALBERT G. MORHART, RAYMOND D. SHEPARD, ALFRED G. ZIMMERMAN, FRED C. EIBELL, RICHARD K. STEINMAN and PAUL A. SEIBOLD, Individually;
Defendants.

No. 512.

BENEFICIAL INDUSTRIAL LOAN CORPORATION,
Petitioner,

*against*

Honorable WILLIAM F. SMITH, a Judge of the United States District Court for the District of New Jersey; and HANNAH COHEN, Executrix of the Estate of Sol Cohen, deceased, and DAVID F. COHEN, Intervenors,
Respondents.

*ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.*

## BRIEF FOR BENEFICIAL INDUSTRIAL LOAN CORPORATION.

These are proceedings to review a decree of the Court of Appeals for the Third Circuit which reversed an order

of the District Court for the District of New Jersey, denying a motion of Beneficial Industrial Loan Corporation for security for expenses and counsel fees, and a decree of that Court dismissing a petition by Beneficial Industrial Loan Corporation for a writ of certiorari or mandamus. This consolidated brief will cover the points raised in both No. 442 and No. 512, and the parties will hereinafter be referred to according to their alignment in No. 442.

## Opinions Below.

The opinion of the Court of Appeals (R. 39) is reported in 170 F. 2d 44. The opinion of the District Court (R. 22) is reported in 7 F. R. D. 352.

## Jurisdiction.

The jurisdiction of this Court is invoked under 28 U. S. C. §§1254(1) and 2101(c).

## The New Jersey Statute and the Nature of the Right Created Thereunder.

All of the questions involved on this review concern the enforcement of rights under Chapter 131 of the New Jersey Laws of 1945 (R. S. Cum. Supp. 14:3-15, 14:3-17), which provides as follows:

> "In any action instituted or maintained in the right of any domestic or foreign corporation by the holder or holders of shares, or of voting trust certificates representing shares, of such corporation having a total par value or stated capital value of less than five per centum (5%) of the aggregate par value or stated capital value of all the outstanding shares

of such corporation's stock of every class, exclusive of shares held in the corporation's treasury, unless the shares or voting trust certificates held by such holder or holders have a market value in excess of fifty thousand dollars ($50,000.00), the corporation in whose right such action is brought shall be entitled, at any stage of the proceeding before final judgment, to require the complainant or complainants to give security for the reasonable expenses, including counsel fees, which may be incurred by it in connection with such action and by the other parties defendant in connection therewith for which it may become subject pursuant to law, its certificate of incorporation, its by-laws or under equitable principles, to which the corporation shall have recourse in such amount as the court having jurisdiction shall determine upon the termination of such action. The amount of such security may thereafter, from time to time, be increased or decreased in the discretion of the court having jurisdiction of such action upon showing that the security provided has or may become inadequate or is excessive.

* * * * * *

"This act * * * shall take effect immediately and shall apply to all such actions, suits or proceedings now pending in which no final judgment has been entered, and to all future actions, suits and proceedings."

It will be noted that while the statute speaks in terms of "security", it does not in reality involve security in the accepted meaning of that term. It involves rather the posting of property or a bond which *creates, and measures the limits of, a new obligation.* The statute is to be sharply distinguished from the ordinary "security for costs" statute and similar statutes which provide for security for an existing and independent obligation. While the statute was

not drafted in the *form* of a liability, the fact remains that *in substance* it imposes an obligation on plaintiffs in derivative suits to reimburse corporations by requiring the furnishing of

> "security for the reasonable expenses * * * to which the corporation shall have recourse in such amount as the court * * * shall determine upon the termination of such action."

Apart from this right of recourse to the "security", the statute creates no right of reimbursement and no such right exists independently of the statute. Thus, by requiring the payment into court of a sum designated as "security", the statute creates the corporation's right to receive, and the plaintiff's obligation to give, reimbursement. Since the corporation's right is limited to recourse against the "security", it follows that it will be impossible for a corporation to have any right of reimbursement unless security is given.

Thus, as was said by the New York Court of Appeals with respect to a substantially identical statute, it "gives to corporations rights which they had not previously enjoyed" (*Shielcrawt* v. *Moffett*, 294 N. Y. 180, 190, 61 N. E. 2d 435, 440 (1945)).

## Statement of the Case.

The decree of the court below decided a controversy between the respondent corporation and the petitioners, its stockholders, involving the enforcement by respondent against petitioners of its right under Chapter 131 of the New Jersey Laws of 1945 to be reimbursed by the petitioners for expenses and counsel fees in a stockholders' derivative

suit instituted by the petitioners in the right of the respondent.

The proceedings here involved were instituted on August 1, 1946 by the respondent's motion, pursuant to Chapter 131, for an order requiring petitioners to furnish security for the reasonable expenses to which it would be subject if the derivative action proves to be unmeritorious.

It is undisputed that all requirements of Chapter 131 are satisfied. The shares held by both petitioners amount to less than 0.0126% of respondent's capital stock and their total market value never exceeded $8,062.50 (R. 11). And the respondent will be liable, in addition to the expense incurred directly by it in connection with the action, for the expenses, including counsel and accountants' fees, incurred by its officers and directors in connection with a successful defense of the action (R. 10).

The sole issue in the instant proceeding has been purely one of law as to the effect and constitutionality of Chapter 131.

The District Court denied respondent's motion on the ground that Chapter 131 of the New Jersey Laws of 1945 was "procedural" in nature and not binding on the Federal District Court.

The Court of Appeals for the Third Circuit reversed, holding that (1) the order of the District Court denying the motion was reviewable by a direct appeal; (2) the statute in question was binding on the Federal Court, under the doctrine of *Erie R. R.* v. *Tompkins*, 304 U. S. 64 (1938), *Guaranty Trust Co.* v. *York*, 326 U. S. 99 (1945), and *Angel* v. *Bullington*, 330 U. S. 183 (1947), since the statute conferred a new substantial right on the corporation and since it embodied an important public policy of the State of New Jersey, and (3) the contentions of the petitioners that the New Jersey statute was unconstitutional were without merit.

## Questions Presented.

(1) Whether the order of the District Court was reviewable by direct appeal.

(2) Whether the order of the District Court was reviewable by common law writ of certiorari or mandamus, in the event that it was not subject to direct appeal.

(3) Whether Chapter 131 of the New Jersey Laws of 1945 is binding on the Federal District Court (a) under the doctrine of *Erie R. R.* v. *Tompkins*, or (b) under Local Rule 15 of the District Court for the District of New Jersey.

(4) Whether Chapter 131 of the New Jersey Laws of 1945 is constitutional.

## Summary of Argument.

We shall show:

(1) The order of the District Court was appealable. It finally and completely disposed of a substantial right of the respondent. It determined a controversy separate and distinct from the main action both as to parties and subject matter. The rights asserted by the respondent under the statute were in no respect conditioned or qualified by the determination of the issues in the main litigation. If the respondent were denied appellate review until the entry of the final judgment in the main litigation, it would mean that respondent would be deprived of all rights under the statute without any effective appellate review.

(2) Even if the order of the District Court were not subject to direct appeal, it was reviewable by common law writ of certiorari or mandamus. The postponement of

appellate review until after final judgment would thwart appellate jurisdiction by rendering it completely ineffective. And, it is clear that the court below would have granted relief by common law writ if it had not held that the order was subject to direct appeal, provided only it had power to issue such a writ.

(3) The statute is binding on the District Court under the doctrine of *Erie R. R.* v. *Tompkins*. It creates a new substantial right in favor of a corporation and embodies an important public policy of the State of New Jersey. If this statute were controlling on the state courts and not controlling on the federal court, it would bring about the very condition which it was the purpose of *Erie R. R.* v. *Tompkins* to eliminate, and federal jurisdiction would be sought merely to avoid the application of an important state statute. Moreover, if the petitioners' contentions were correct as to the *Erie R. R.* v. *Tompkins* doctrine, the statute would still have to be applied under the District Court's Local Rule 15.

(4) There is no substance to the contention that the statute is unconstitutional. It manifestly has a relation to the correction of an evil found by the New Jersey Legislature to exist. The proper forum for the petitioners to present their criticism of the statute is the New Jersey Legislature. The full faith and credit clause has no application. The statute is limited to acts performed within the State of New Jersey, namely, the prosecution of actions in its courts.

# ARGUMENT.

## I.

### The order of the District Court was reviewable by direct appeal.

The order of the District Court denying respondent's motion for security was a final appealable decision within the meaning of 28 U. S. C. § 1291, *infra*, p. 91, on two separate grounds, namely: (1) it finally disposed of a substantial right of the respondent, and (2) it determined a controversy distinct from the general subject matter of the litigation.

#### 1. The order finally disposed of a substantial right of the respondent corporation.

It is well settled that an appeal will be entertained from an order that would irreparably injure a party by depriving it of a substantial right with absolute finality. In the recent case of *Republic Gas Co.* v. *Oklahoma*, 334 U. S. 62 (1948), this Court pointed out that an order that otherwise might be deemed interlocutory is appealable where "the controversy had proceeded to a point where a losing party would be irreparably injured if review were unavailing" (p. 68); or where there is "any immediate threat of irreparable damage * * * rendering postponed review so illusory as to make the decree 'final' now or never" (p. 70). Under this doctrine, it has been held that

> "A final order results where a court denies a petition by an intervening creditor to establish a prior lien (*Gumbel* v. *Pitkin*, 113 U. S. 545, 548), or a petition by a municipal corporation intervening in a foreclosure suit to enforce a lien for taxes superior

to the mortgage (*Savannah* v. *Jesup*, 106 U. S. 563, 564-565), or one by a chancery receiver appointed by a state court for the delivery of property in the possession of another court. *Ex parte Tiffany*, 252 U. S. 32, 36." Mr. Justice Cardozo, speaking for the Court in *Clark* v. *Williard*, 292 U. S. 112, 118 (1934).

The order of the District Court clearly falls within the above rule for it finally and completely deprived respondent of its right of reimbursement and constituted an "immediate threat of irreparable damage * * * rendering postponed review * * * illusory * * *". The only review which could offer any redress to the respondent is an immediate review.

The petitioners argue that the respondent could be fully protected by an appellate review of the order of the District Court after the final judgment in the main action. This argument simply ignores the plain provisions of the statute.

After the final judgment in the main action, the question of security and reimbursement for expenses therefrom would be moot and appellate review of the order would be meaningless. If, at that time, the District Court's order denying security should be reversed on appeal, the petitioners could no longer be required to give security since under the New Jersey statute security may be required only "at any stage of the proceedings *before* final judgment", which means the final judgment of the trial court. See *Matter of Bailey*, 265 App. Div. 758, 761, 40 N. Y. S. 2d 746, 749 (1st Dept. 1943), aff'd 291 N. Y. 534, 50 N. E. 2d 653 (1943).

Unless security is obtained before such final judgment, all rights conferred under the statute would be wholly lost. For as pointed out above on page 4, the right of reim-

bursement for expenses is limited solely to recourse to the "security".

Thus, unless permitted to appeal directly from the order of the District Court, the respondent would irretrievably lose an effective appellate review of an order depriving it completely of the only means of protection against possible damage in excess of $100,000. As pointed out by Judge Frank in his concurring opinion in *Aspinook Corp.* v. *Bright,* 165 F. 2d 294, 295 (2d Cir. 1947), cert. denied 333 U. S. 846 (1948), in such a case a corporation "will suffer an irreparable loss through an unreviewable erroneous order of the district court."

The unreported decision of the divided Court of Appeals for the Second Circuit, referred to in the *Aspinook* case, *supra,* holding without opinion that an order of the kind here in issue was not final and thus not appealable, is, we submit, erroneous.

It appears from the record in the *Aspinook* case that the court was not sufficiently informed as to the authorities, the principles of law, and the effect of the statute involved. The motion to dismiss the appeal was heard on only 5 days' notice. No memorandum or brief was submitted in opposition to the motion. The only paper submitted in opposition was a 6-page affidavit, which had no citation of authorities and which failed to give an adequate analysis of the principles and facts involved.

It is apparent from the opinion in *Aspinook Corp.* v. *Bright, supra,* where the court denied the corporation's petition for mandamus (after having dismissed its appeal), that it misunderstood the nature of the statute and the effect of the order before it. The basic question before the court on both the motion to dismiss the appeal and the petition for mandamus was whether the corporation would be finally deprived of rights under the statute without an

immediate review. The premise adopted by the majority of the court in dealing with this basic question is shown by the following statement in such opinion (165 F. 2d, at p. 295):

> "Here, if after final judgment either party appeals to this court, full review and protection of the parties can be afforded; only in the single instance where judgment goes against the suing plaintiffs *and* they choose not to appeal will there be the chance of the corporation suffering loss * * *."

This premise is untenable. Contrary to the above quoted statement, the corporation could receive the protection to which it was entitled under the statute *in no instance* without having a right to an immediate review.

In the first place, a plaintiff might abandon the prosecution of the action at any stage before final judgment, and after subjecting the corporation to very substantial expenses. Here, there would be no final judgment to be appealed and hence under the *Aspinook* decision, the corporation would have finally and completely lost its rights under the statute.

In the second place, as has been pointed out, *supra*, the statute expressly limits the requirement for security to any stage "*before* final judgment". Therefore, after final judgment, the corporation is no longer entitled to security and even if an appeal should be taken from the final judgment, whether by the plaintiff or the individual defendants, the motion for security would have become moot. Thus, under the *Aspinook* decision, the corporation would be finally deprived of all rights under the statute.

In the third place, even under the erroneous assumption made in the *Aspinook* decision that if "either party" appealed from an adverse final judgment, the appellate court

could order security to be given, the corporation would still have been finally deprived of the protection given by the statute. For the plaintiff could then refuse to put up the security with impunity, and leave the corporation to bear the expenses to which it has already been subjected.

In any event, review of the order on appeal from the final judgment in the main action can never give to the corporation the kind of protection to which it is entitled under the statute, namely, security before the damage is inflicted. A basic purpose of security is to eliminate the risk of collectibility and no decision of an appellate court can eliminate that risk after the damage has been done.

The fact that the Court of Appeals for the Second Circuit misunderstood the question of law before it is well illustrated by the statement which it made with respect to the instance in which it recognized that the corporation would be denied the protection of the statute. It said (165 F. 2d, at p. 295): "Such burdens accompanying success in litigation are of course usual in our jurisprudence; * * *." This instance was the case where the plaintiff failed to appeal from an adverse judgment. Obviously, a judgment denying a recovery for the benefit of the corporation would not constitute "success in litigation" so far as the corporation is concerned. The only result of the litigation as to it would be the loss which the statute was designed to prevent. Moreover, whatever the burdens might be in a litigation in the absence of statutory protection, constitutes no reason for ignoring a statute which is expressly designed to eliminate such burdens.

There is no doubt that in the absence of immediate review the respondent would suffer irreparable injury by being deprived of its right to security and reimbursement with absolute finality.

**2. The order determined a controversy distinct from the general subject matter of the litigation.**

Another well-established basis for the appealability of the order is the doctrine which has been summarized as follows in 10 *Cyc. Fed. Procedure* (2d ed., 1943), p. 231:

> "The term 'final decision' as employed in the jurisdictional statute does not mean necessarily such decisions or decrees only which finally determine all the issues presented by the pleadings. While these are undoubtedly final decisions, the terms are not limited to them, but also apply to a final determination of a collateral matter distinct from the general subject of litigation, affecting only the parties to the particular controversy, and finally settling that controversy."

Of the many cases in which this Court has announced this rule, it will suffice to refer by way of example to *United States* v. *River Rouge Improvement Co.*, 269 U. S. 411, 414 (1926), where this Court said:

> "While the general rule requires that a judgment of a federal court shall be final and complete before it may be reviewed on a writ of error or appeal, it is well settled that an adjudication final in its nature as to a matter distinct from the general subject of the litigation and affecting only the parties to the particular controversy, may be reviewed without awaiting the determination of the general litigation."

The present order falls within this rule for two reasons: (a) Because of the alignment of the parties to the controversy it determines, and (b) because of the subject matter of that controversy.

The fundamental difference between the instant controversy and the main action leaves no doubt as to its collateral nature. The main action is brought on behalf of

the respondent corporation, which is merely a nominal party thereto, by the petitioners against the individual defendants. In the instant controversy, on the other hand, the respondent seeks to enforce rights of its own against the petitioners, so that in this proceeding the litigation is between the respondent and the petitioners; and none of the individual defendants are involved in this controversy and will be in no way affected by its disposition. The controversy thus falls within the doctrine of the *River Rouge Improvement Co.* case, *supra,* as "a matter distinct from the general subject of the litigation and affecting only the parties to the particular controversy."

The same result follows from the nature of the right asserted in this controversy, namely, a right to counsel fees and expenses. A controversy involving such a right has been held to be, without more, a collateral matter, having a distinct and independent character. In *Trustees* v. *Greenough,* 105 U. S. 527 (1881), this Court held an order awarding expenses and counsel fees to the plaintiff in a representative bondholder's suit to be appealable, saying (at p. 531):

> "The first question, however, is whether these orders do or do not amount to a final decree, upon which an appeal lies to this court. They are certainly a final determination of the particular matter arising upon the complainant's petition for allowances, and direct the payment of money out of the fund in the hands of the receiver. Though incidental to the cause, the inquiry was a collateral one, having a distinct and independent character, and received a final decision."

In *Sprague* v. *Ticonic Bank,* 307 U. S. 161 (1939), the plaintiff had petitioned the District Court for the allowance of counsel fees and expenses, after the merits of the action

had been finally decided by this Court. The District Court held that it had no authority to grant the petition on the ground that it had no further function to perform other than to carry out the mandate of the Supreme Court. The Circuit Court of Appeals affirmed for the reasons stated by the District Court, and for the further reason that the term of court at which the decree was entered had long since passed. This Court reversed on the ground that under the doctrine of *Trustees* v. *Greenough, supra,* the issue of an allowance of counsel fees was separate and distinct from the main litigation and was, therefore, not covered by either the original decree or the appellate mandates. As to the requirements of terms of court, the Court said (at p. 170):

> "Since we view the petition for reimbursement as an independent proceeding supplemental to the original proceeding and not a request for a modification of the original decree, the suggestion of the Circuit Court of Appeals—that it came after the end of the term at which the main decree was entered and therefore too late—falls."

The grounds on which the petitioners seek to distinguish *Trustees* v. *Greenough* and *Sprague* v. *Ticonic Bank, supra,* are untenable. The *Greenough* case is sought to be distinguished because the order there involved an award of expenses and counsel fees, and not security therefor. But, as has been shown *supra,* this attempt to differentiate between the right to security and the right to reimbursement for expenses and counsel fees rests upon a misunderstanding of the meaning and effect of Chapter 131. Under the New Jersey statute, it is the posting of the security which creates the respondent's right to reimbursement. Thus, the respondent's motion under Chapter 131 was an assertion of its right of reimbursement for counsel fees

and expenses and as such was of the same nature as the application in the *Greenough* case. That case is further sought to be distinguished on the ground that there the motion was granted, whereas here the motion was denied. If a proceeding is collateral and separate from the main litigation, *any* determination thereof is a final appealable decision. Reference is made in this connection to *Gelberg* v. *Richardson*, 82 F. 2d 314 (9th Cir. 1936), where an order *denying* an application for counsel fees was held to be a final appealable decision. Finally, the petitioners' analogy to summary judgment is inapplicable, for a motion for a summary judgment does not relate to a matter distinct from the issues of the litigation, but on the contrary seeks a determination of those very issues.

The petitioners seek to distinguish the *Sprague* case on the ground that there the motion for expenses and counsel fees was made after a determination of the merits. But the court below relied on the *Sprague* case merely for the proposition that an issue respecting the allowances of counsel fees and expenses is separate and distinct from the main litigation. This Court clearly so held in the *Sprague* case. It follows that the instant order, which determined such an issue, was an appealable decision.

The two main arguments advanced by petitioners to support their contention that the order of the District Court did not determine a separate controversy have no merit.

In the first place, they argue that in order to have a separate controversy the question "must be so distinct and unrelated to the other issues in the case that further proceedings in the trial court can have no effect on the question sought to be appealed". Even if the test stated by the petitioners be adopted (and, as shown above, that is not the accurate test), the facts with respect to the

matter decided by the order of the District Court fully meet the test. Further proceedings in the trial court with respect to the main action can have no effect whatever on the question of whether or not respondent has a right to require the petitioners to put up security to protect it against loss. To be sure, the proceedings in the trial court with respect to the merits of the main action will have a relationship to whether or not respondent suffers a loss and hence should have recourse against such security. But that is not the controversy which was before, or was determined by, the District Court. The controversy which was before the District Court, namely, whether or not the petitioner had a right to be protected with security from which reimbursement might be obtained, is in no way conditional upon, or qualified by, the further proceedings in the trial court in the main action.

In the second place, the petitioners argue that "if the denial of security is an independent decision, so too * * * would be an order fixing the amount of the security or amending or refusing to amend it"; and that the necessary consequence would be numerous "interlocutory appeals". We submit that this is wholly imaginary. The fixing of the amount of the security rests in the discretion of the District Court. That is a far cry from a determination of whether or not the respondent has *any* right at all under the statute in question. There is no reason to believe that once the appellate courts settle the basic question as to whether the corporation has a right to proceed under the statute, the district judges will fix the amount of security arbitrarily in unreasonable amounts. Moreover, the determination as to whether or not a corporation may proceed under the statute involves a final and complete determination; whereas the fixing of the amount of security from time

to time might well be regarded as interlocutory steps taken within one proceeding to enforce the rights conferred by the statute.

## II.

**Even if the order of the District Court was not subject to direct appeal, it was reviewable by common law writ of certiorari or mandamus.**

Even if the order should be held not to be an appealable final decision, the court below had authority to review it by common law writ of certiorari or mandamus.

It is, of course, not open to doubt that under 28 U. S. C. §1651(a), *infra*, p. 91, the court below has power to issue the common law writs in aid of its appellate jurisdiction.

> *Ex parte Peru*, 318 U. S. 578, 584 (1943);
> *McClellan* v. *Carland*, 217 U. S. 268, 279 (1910).

And the present case meets all the requirements for the exercise of that power.

### (1)

The court below clearly had appellate jurisdiction with respect to the order of the District Court. Even if the order was not directly appealable, it was subject to appellate review by the court below on appeal from the final judgment in the main action. The Court of Appeals was apparently of the opinion that such potential appellate jurisdiction was not sufficient to confer jurisdiction to issue a common law writ, saying (R. 43-44):

> "If the order of the court below is not appealable we would not have the right to issue the writ

since insofar as the instant litigation is concerned this court would have no appellate jurisdiction to protect."

However, this view is clearly erroneous. In the first place, if review of an order by common law writ may be had only if such order is directly appealable, there would never be a need for the issuance of the writ and the court's jurisdiction to issue such writ would for all practical purposes be abolished. In the second place, ever since the decision of this Court in *McClellan* v. *Carland, supra;* it has been settled law that in a proper case the common law writs may be issued in aid of the court's *potential* appellate jurisdiction, before actual appellate jurisdiction has been obtained. In the *McClellan* case, this Court said (217 U. S. at pp. 279-280):

> "In this case it appears that the original action commenced in the Circuit Court of the United States might have been taken on appeal to the Circuit Court of Appeals. * * * There are not wanting decisions in the Federal courts holding different views as to the right to issue such writs as are involved in this case, before the appellate court has actually obtained jurisdiction of the case. There are expressions in opinions of this court to the effect that such writs issue in aid of a jurisdiction actually acquired. But we think it the true rule that where a case is within the appellate jurisdiction of the higher court a writ of mandamus may issue in aid of the appellate jurisdiction which might otherwise be defeated by the unauthorized action of the court below."

**Accord:**

*Ex parte United States*, 287 U. S. 241, 246 (1932); *United States* v. *District Court*, 334 U. S. 258, 263 (1948).

There can thus be no doubt that the court below had the power to issue a common law writ to bring the order of the District Court before it for review.

(2)

The instant case is an appropriate one for the exercise of the court's power to issue a common law writ in aid of its appellate jurisdiction. It is well settled that the issuance of such writ is proper where otherwise appellate review of the ruling of the lower court would be thwarted. As this Court said in *United States* v. *District Court*, 334 U. S. 258, 263 (1948): "That power [to issue a writ of mandamus] protects the appellate jurisdiction which might be otherwise defeated * * *". See also *Roche* v. *Evaporated Milk Association*, 319 U. S. 21, 26 (1943).

As shown above and as recognized by the court below, the order of the District Court is beyond correction after final judgment in the main action and appellate jurisdiction would thus be thwarted if review is postponed until then.

On the basis of such circumstances, this Court in the case of *De Beers Consolidated Mines* v. *United States*, 325 U. S. 212 (1945), granted a common law writ of certiorari to review an interlocutory order of the District Court which restrained the defendants in an anti-trust suit from disposing of any of their property in the United States during the pendency of the action and until their compliance with any decree rendered against them. Mr. Justice Roberts, delivering the opinion of the court, said (at p. 217):

> "* * * no decision of the suit on the merits can redress any injury done by the order; and therefore unless it can be reviewed under §262 it can never be corrected if beyond the power of the court below."

This is precisely the situation here, if the order is held to be interlocutory in character.

Appellate jurisdiction may also properly be protected in the instant case by the issuance of a writ of mandamus.

As stated by this Court in *Ex parte Peru*, 318 U. S. 578, 583 (1943):

> "The historic use of writs of prohibition and mandamus directed by an appellate to an inferior court has been to exert the revisory appellate power over the inferior court. The writs thus afford an expeditious and effective means of confining the inferior court to a lawful exercise of its prescribed jurisdiction, *or of compelling it to exercise its authority when it is its duty to do so.*" (Italics added.)

Chapter 131 of the New Jersey Laws of 1945 gives to corporations an absolute right to require a stockholder owning less than the required number of shares to give security for counsel fees and expenses and an absolute right to have recourse thereto in the event that the plaintiff-stockholder is unsuccessful. As the Court of Appeals stated in its opinion, "* * * the wording of R. S. 14:3-15 leaves no discretion in the court below to require security of the plaintiff or the intervener. The only discretion conferred on the court by R. S. 14:3-15 is as to the *amount* of the security and of the subsequent reimbursement" (R. 59). In the instant case, the District Court refused to fix the security to be posted by the petitioners, which was its mandatory duty under the statute, and held that it was without jurisdiction to allow counsel fees and expenses. Under these circumstances, mandamus was a proper remedy to direct the District Court to exercise its jurisdiction and to fix the amount of security as required by the statute.

A case directly in point is *Ex parte United States*, 287 U. S. 241 (1932). There, the District Court had denied the government's petition for a bench warrant for the arrest

of a person duly indicted by the grand jury. This Court granted mandamus to review the order, saying (at p. 249):

> "The theory of the court below is that its denial of the petition of the government for a bench warrant was an exercise of its judicial discretion, and, therefore, not reviewable by mandamus. This view of the matter cannot be sustained. The question whether there was probable cause for putting the accused on trial was for the grand jury to determine, and the indictment being fair on its face, the court to which it was returned, upon the application of the United States attorney, should have issued the warrant as a matter of course."

Here, likewise, the District Court had no discretion in the matter, but should have ordered the posting of security by the plaintiff and intervener "as a matter of course", and its failure to do so, if not appealable, should have been corrected by the Court of Appeals in the exercise of the powers conferred upon it by 28 U. S. C. §1651(a).

It follows from the foregoing that the Court of Appeals for the Second Circuit erred when it held in *Aspinook Corp.* v. *Bright, supra,* that the matter here involved was not one in which mandamus should issue. We have already shown *supra,* at pp. 10-12, that the court fell into error because of its faulty analysis of the nature and effect of the statute. Thus, the court in the *Aspinook* case seems to have relied in part on *Ex parte Fahey,* 332 U. S. 258 (1947), in which this Court stated that a writ of mandamus, being an extraordinary remedy, should be resorted to only where appeal is a clearly inadequate remedy. This was not the case in *Ex parte Fahey,* which involved a petition for a writ of mandamus to review an order of the District Court *allowing* counsel fees, since the petitioner could obtain restitution if an appeal after final judgment resulted in a reversal of

the allowance. However, as shown above, in the *Aspinook* case and in the instant case a review after final judgment would be meaningless, and thus these cases constitute the very kind of "extraordinary cause" for which the extraordinary writs are intended.

The court's denial of the petition for mandamus was further based on the ground that it was not dealing with "a case of usurpation of power, [where] 'the lower court is clearly without jurisdiction,' instead of 'a mere error in the exercise of conceded judicial power' " (165 F. 2d, at p. 295). In making this statement, the court failed to recognize that the statute made it mandatory to require the posting of security and the decision of the District Court amounted to a refusal to exercise its jurisdiction in violation of the mandate of the statute. For the correction of such a refusal, mandamus is an appropriate remedy, if it should be held that the order is not reviewable immediately by appeal.

Thus, the reasons stated in the *per curiam* opinion in the *Aspinook* case do not support the decision of the court. Moreover, the court in that case had no doubt as to its power to issue the writ, but merely refused to exercise its discretion to do so. In the instant case, it is clear from the opinion of the court below that it would have granted the writ if it had held the order not to be appealable, provided only it had the power to do so. It is submitted that the court below had such power and that it would have been appropriate for it to exercise that power in the instant case, in the absence of the remedy by direct appeal.

## III.

**Chapter 131 of the New Jersey Laws of 1945 is binding on a Federal District Court sitting in New Jersey.**

It is settled law, at least since this Court's decision in *Guaranty Trust Co.* v. *York*, 326 U. S. 99 (1945), that in determining whether a state statute is binding on the federal courts under the Rules of Decision Act, 28 U. S. C. 1652, *infra*, p. 91, or the doctrine of *Erie R. R.* v. *Tompkins*, 304 U. S. 64 (1938), the answer will not depend on a technical classification of the statute as "substantive" or "procedural". As stated by Mr. Justice Frankfurter, speaking for the Court in the *Guaranty Trust Co.* case, at page 109:

> "*Erie R. Co.* v. *Tompkins* was not an endeavor to formulate scientific legal terminology. It expressed a policy that touches vitally the proper distribution of judicial power between State and federal courts."

If the statute creates a substantial right or embodies a public policy of the State, it will be enforced in the Federal Court, irrespective of how it may be classified for purposes other than the enforcement of the *Erie R. R.* v. *Tompkins* rule.

We shall show that the policy of the *Erie* case requires enforcement of the New Jersey statute by the District Court.

Moreover, even under a technical classification of the statute as "substantive" or "procedural", the result will be the same in any case. For, obviously, the statute must be either one or the other. If it is "substantive" in character, it must be enforced here under the Rules of Decision Act and the rule of *Erie R. R.* v. *Tompkins*. If it is

"procedural", we shall show that it must be enforced by the District Court under its own Local Rule 15.

**1. Chapter 131 creates a substantial right and embodies an important public policy of the State of New Jersey which must be enforced by the Federal Court.**

The only basis which the District Court had for assuming jurisdiction over this litigation is diversity of citizenship. The action does not involve any rights granted or duties imposed by federal law. It is an action involving solely state law. It is established that in such a case a federal court must, under the Rules of Decision Act (28 U. S. C. §1652) and under the Constitution itself, adjudicate all substantial rights as they would have been adjudicated by the state courts.

This principle was laid down in *Erie R. R.* v. *Tompkins*, 304 U. S. 64 (1938). Referring to the practice under the case of *Swift* v. *Tyson*, 16 Pet. 1 (U. S. 1842), which sanctioned different results in a litigation depending upon whether it was tried in a state or federal court, the Court said that the "mischievous results" of the doctrine had become apparent; that it made rights vary "according to whether enforcement was sought in the state or in the federal court"; that the privilege of "selecting the court in which the right should be determined was conferred upon the non-citizen"; and that the "doctrine rendered impossible equal protection of the law." The Federal Constitution required, said the Court, that "except in matters governed by the Federal Constitution or by Acts of Congress, the law to be applied in any case is the law of the state."

The case of *Guaranty Trust Co.* v. *York*, 326 U. S. 99 (1945), made it clear that this constitutional doctrine requires that the law of the state to be applied by the federal

court includes *all* the law, whether it be called substantive or procedural, so long as it makes a substantial difference to the rights of the parties in the action. This Court said (p. 109):

> "And so the question is not whether a statute of limitations is deemed a matter of 'procedure' in some sense. The question is whether such a statute concerns merely the manner and the means by which a right to recover, as recognized by the State, is enforced, or whether such statutory limitation is a matter of substance in the aspect that alone is relevant to our problem, namely, does it significantly affect the result of a litigation for a federal court to disregard a law of a State that would be controlling in an action upon the same claim by the same parties in a State court?"
>
> "* * * In essence, the intent of that decision [Erie R. Co. v. Tompkins] was to insure that, in all cases where a federal court is exercising jurisdiction solely because of the diversity of citizenship of the parties, the outcome of the litigation in the federal court should be substantially the same, so far as legal rules determine the outcome of a litigation, as it would be if tried in a State court."

Thus, the only question is, does the statute here involved confer a substantial right on a corporation, or, phrased differently, would the refusal of the federal court to give effect to the statute leave all the parties in substantially the same position as if the action had been tried in the New Jersey state court?

If the protection of a corporation and its stockholders against heavy loss (which, as has been alleged without denial, will be at least $125,000) is not a substantial right, it is difficult to know what a substantial right means. Under the

imilar New York statute, plaintiffs have been required to ost security in very substantial amounts; e.g., security as fixed in the sum of $75,000 in *Tichner* v. *Andrews*, N. Y. . J., Feb. 26, 1948, p. 721, col. 2 (Sup. Ct., N. Y. Co.) and 100,000 in *Berger* v. *Ewing*, N. Y. L. J., Feb. 21, 1949, . 651, col. 1 (Sup. Ct, N. Y. Co.). If a federal court should efuse to apply this state statute, surely the outcome of a iven derivative stockholders' action in the federal court ould not be "substantially the same * * * as it would be if ied in a State court." In the state court, the corporation ould obtain reimbursement from the plaintiff through re- ourse to the security. In the federal court, on the other and, the corporation would stand the loss involved if the ate law is not applied.

A refusal to apply the state statute would produce to a arked degree the "mischievous results" that this Court ndemned in *Erie R. R.* v. *Tompkins*. It would make the ghts of stockholders and corporations vary according to hether derivative suits were brought in the state or in e federal court. It would inevitably cause plaintiffs to nploy objectionable manoeuvers to establish the requisite versity of citizenship and thus avoid the jurisdiction of ate court.

The recent case of *Angel* v. *Bullington*, 330 U. S. 183 947), well shows the broad scope of the doctrine of *Erie R. R.* v. *Tompkins* and establishes that a state statute is nding on the federal courts where it expresses a public olicy of the state, irrespective of whether that statute ay be labeled "procedural" or "substantive" for other rposes.

In that case, the plaintiff mortgagee had brought an tion in a North Carolina state court against the defend- t mortgagor for a deficiency judgment. Although the

plaintiff recovered judgment in the trial court, the Supreme Court of North Carolina reversed and dismissed the action, holding that it was barred by a North Carolina statute which provided that a mortgagee "shall not be entitled to a deficiency judgment." In upholding the constitutionality of the statute, the court stated it to be merely a limitation on the jurisdiction of the state courts, saying:

> "The statute operates upon the adjective law of the State, which pertains to the practice and procedure, or legal machinery by which the substantive law is made effective, and not upon the substantive law itself. It is a limitation of the jurisdiction of the courts of this State."

The plaintiff did not appeal this decision to this Court, but commenced a new action for a deficiency judgment in the Federal District Court for the Western District of North Carolina. He recovered judgment in the District Court, and this decision was affirmed by the Circuit Court of Appeals. This Court, however, reversed and held that the statute which deprived the state courts of jurisdiction, likewise precluded the federal courts from granting relief. The Court stated the principles of law which require the federal courts, in a diversity of citizenship case, to give effect to the public policy of the State as follows (at pp. 191-192):

> "It is suggested that the North Carolina Supreme Court construed the North Carolina statute to close only the North Carolina State courts but not the federal court sitting in North Carolina. In the first place, the North Carolina Supreme Court said no such thing. It construed the statute expressive of State policy and spoke only of the jurisdiction of the State courts because it was concerned only with the State courts. Secondly, it is most incongruous to attribute

> to the legislature and judiciary of North Carolina the imposition of a restriction against all its citizens from suing for a deficiency judgment, while impliedly authorizing citizens of other states to secure such deficiency judgments against North Carolinians. Thirdly, a North Carolina statute, upheld by the highest court of North Carolina, is of course expressive of North Carolina policy. The essence of diversity jurisdiction is that a federal court enforces State law and State policy. If North Carolina has authoritatively announced that deficiency judgments cannot be secured within its borders, it contradicts the presuppositions of diversity jurisdiction for a federal court in that State to give such a deficiency judgment. North Carolina would hardly allow defeat of a State-wide policy through occasional suits in a federal court. What is more important, diversity jurisdiction must follow State law and policy. A federal court in North Carolina, when invoked on grounds of diversity of citizenship, cannot give that which North Carolina has withheld. Availability of diversity jurisdiction which was put into the Constitution so as to prevent discrimination against outsiders is not to effect discrimination against the great body of local citizens."

It is clear that Chapter 131 of the New Jersey Laws of 1945 embodies an important public policy of that State. It is the result of a legislative finding that there was a specific evil to be corrected, namely, having corporations and their stockholders subjected to heavy losses as a result of unjustifiable litigation prosecuted by a holder of only a few shares of stock, having no real economic interest in the outcome of the litigation. In approving the legislation, the Governor pointed out that its purpose is

> "to deter the filing of irresponsible suits by persons who either have no legitimate cause of action or who

> institute such action more for the personal gain of a settlement out of court than in the interest of the corporation or its stockholders. These suits involving the highly complicated transactions of modern corporate business are very costly to defend, regardless of whether or not they may be justifiable. For this reason they have been the subject of great abuse and have been used to harass corporate officers and directors with baseless litigation. * * * It is a minimum protection for corporations and their officers and directors, against 'strike suits' * * *" (R. 45).

That a public policy of a state, expressed in a statute conferring upon a party to a litigation the right to be reimbursed for counsel fees, must be enforced by the federal courts, was decided by this Court ten years prior to its decision in *Erie R. R.* v. *Tompkins*. In *Sioux County* v. *National Surety Co.*, 276 U. S. 238 (1928), it was held that a Nebraska statute providing that in actions upon certain insurance policies the court "shall allow the plaintiff a reasonable sum as an attorney's fee in addition to the amount of his recovery, to be taxed as a part of the costs," must be applied by the federal courts. Brushing aside arguments based on the fact that the Supreme Court of Nebraska had held the statute procedural for one purpose, Mr. Justice Stone, speaking for the Court, said (at p. 243):

> "But the question before the Nebraska court in the cases cited was not that with which we are now concerned. Whether this liability for an attorney's fee, assumed by entering into an insurance contract after the enactment of the statute providing for the liability, may be enforced in the federal courts does not depend on any nice distinctions which may be taken between the right created and the remedy given. *Disregarding mere matters of form it is clear that it is the policy of the state to allow plaintiffs to*

*recover an attorney's fee in certain cases*, and it has made that policy effective by making the allowance of the fee mandatory on its courts in those cases. *It would be at least anomalous if this policy could be thwarted and the right so plainly given destroyed by removal of the cause to the federal courts.*" (Italics supplied.)

A decision in conflict with the principle of law relied on by the respondent is *Boyd* v. *Bell*, 64 F. Supp. 22 (S. D. N. Y. 1945). The court there held that section 61-b of the New York General Corporation Law, which is similar to the statute here involved, was procedural and that the federal court was not required to give effect to it.

It is clear that the decision of *Boyd* v. *Bell* is inconsistent with the decisions of this Court just discussed. Apparently, the *Sioux County* case was not called to the attention of the District Court. Moreover, an analysis of the decision discloses the erroneous basis on which it was reached.

In the first place, the whole basis upon which the court rested its finding that the statute was procedural is plainly unsound. The question was whether the right which the statute conferred on corporations was substantive or procedural under the doctrine of *Erie R. R.* v. *Tompkins*. But in deciding that the statute was procedural, the court gave no consideration whatever to the nature of the right conferred on corporations. If the court had analyzed the real issue involved, it seems clear that it would have held the statute to be substantive in nature, for how else was the right on the part of the corporation to be protected against losses up to and in excess of $100,000 to be classified?

In the second place, the court in *Boyd* v. *Bell* misapplied the doctrine of *Guaranty Trust Co.* v. *York*. Although it purported to apply the rule of *Guaranty Trust Co.* v. *York*,

it fell into the error of basing its decision solely on the proposition that the adjudication of the claims asserted against the individual defendants on behalf of the corporation would not be affected by the statute. In this connection the District Court said (at p. 24):

> "These cases all emphasize as substantive rules and law which clearly have a bearing upon the direction in which judgment will go, in the result of the litigation. Here section 61-b can have no such bearing. * * * Whether the security required was given, or not asked, the determination of the merits would not be in any way affected. Plaintiff would still be granted or denied relief depending upon the proof, and not upon compliance with the statute."

The quoted language makes it apparent that the District Court, in attempting to apply the test of the *York* case, considered merely the effect of the non-application of the statute on the individual defendants' liability, and completely ignored its effect on the *corporation's* rights. There is nothing in the decision of this Court in the *York* case which justifies such a position. We have shown, (*supra* pp. 13-16), that a motion under a statute like the one in issue involves a matter distinct from the general subject of litigation. Consequently, the proper inquiry, under the rule of the *York* case, is whether the non-application by the federal court of the state statute would "significantly affect the result" of the separate controversy between the plaintiff-stock-holder and the corporation and it is self-evident that it not only significantly "affects" the controversy but actually decides it.

Even looking at the main litigation, the rule of the *York* case that "the outcome of the litigation in the federal court should be substantially the same * * * as it would be if tried in a State court" would not be complied with, if

in the state court the unsuccessful plaintiff-stockholder must pay the counsel fees of the defendants, while in the federal court that burden falls upon the corporation.

Besides misconceiving the "substantially different result" test of the *York* case, the court in *Boyd* v. *Bell* completely ignored the fact that the statute expressed an important public policy of the state. It is clear under *Angel* v. *Bullington, supra*, which was decided after *Boyd* v. *Bell*, that the District Court for the Southern District of New York erred in failing to give effect to the New York State public policy, irrespective of whether the statute is classified as "procedural" or "substantive".

In light of the decision in *Angel* v. *Bullington*, a contrary result was reached in *Donovan* v. *Queensboro Corp.*, 75 F. Supp. 131 (E. D. N. Y. 1947), appeal dismissed March 23, 1948 (2d Cir., unreported), cert. denied 335 U. S. 804 (1948), where the court granted a motion by a corporation to compel the plaintiff to furnish security in the sum of $50,000, holding that Section 61-b of the New York General Corporation Law must be given effect in the federal court. Dealing with the argument that the statute was merely a procedural matter, the court said (at p. 133):

> "Apparently in regard to the argument that this statute is merely a procedural matter, the Court of Appeals of the State of New York (opinion of Judge Lehman, Ch. J.), Shielcrawt *v.* Moffett, 294 N. Y. 180, decided at page 190: 'The statute we are considering differs from such purely procedural statutes both in purpose and effect.' The opinion then goes on to express an important difference. It plainly indicates a definite policy for the protection of defendant residents of the state and, 'creates a remedy for a wrong for which previously there was no remedy.'
>
> . . . . . .

> "Recently it has been plainly indicated by the Supreme Court of the United States that discrimination against citizens of a State should be avoided, where possible, in the use of diversity of citizenship actions. I refer for this principle, although the facts in that case are different, to the case of Angel *v.* Bullington, 330 U. S. 183, (decided February 17, 1947); Mr. Justice Frankfurter writing for the court states: 'What is more important, diversity jurisdiction must follow State law and policy. A federal court in North Carolina, when invoked on grounds of diversity of citizenship, cannot give that which North Carolina has withheld'."

Thus, in enforcing the state statute, the court in the *Donovan* case relied on *Shielcrawt* v. *Moffett* and *Angel* v. *Bullington*. It is important to note that in *Boyd* v. *Bell*, *supra*, Judge Bright did not even refer to *Shielcrawt* v. *Moffett* and that *Angel* v. *Bullington* had not then been decided by this Court.

There can thus be no doubt that under *Sioux County* v. *National Surety Co.*, *Erie R. R.* v. *Tompkins*, *Guaranty Trust Co.* v. *York* and *Angel* v. *Bullington*, *supra*, the New Jersey statute must be enforced by a federal district court sitting in New Jersey.

On the basis of the foregoing considerations, Professor Moore states with respect to this question (3 *Federal Practice* (2d ed. 1948) 3505) that

> "To pursue the theory that federal courts can handle stockholder-corporate litigation more justly, if they are free of the statute, than their sister state courts across the street, who are fettered by the 'unwise' statutory policy, takes us back to the days of *Swift* v. *Tyson*."

The petitioners' arguments to the contrary are invalid.

In the first place, petitioners argue that the order of the District Court was merely concerned with the "procedural" matter of furnishing security and had nothing to do with any right of the respondent to be reimbursed for expenses. As shown above, page 4, this argument is fallacious. For under the statute, the denial of "security" at the same time denies any right to reimbursement for the expenses in question. The petitioners misconceive the nature of the statute when they assert that the posting of security and the creation of the right of reimbursement are "two distinct questions." The right to reimbursement is limited to, and created by, the security which is posted. The denial of security is a denial at the same time of right to reimbursement which is limited to "recourse" against such security.

In the second place, the petitioners' argument that Rule 23(c) of the Federal Rules of Civil Procedure prevents the application of the New Jersey statute is without merit. Rule 23(c) is entirely different from Chapter 131; it deals solely with the mechanics for the *settlement* of a derivative action. It does not give a corporation any right whatever to obtain reimbursement for expenses to which it may be subjected as a result of an unmeritorious derivative action. Rule 23 does not deal with that subject at all. Chapter 131 is thus in no way inconsistent with Rule 23. Carried to its logical conclusion, the petitioners' position would lead to the result that all state law relating to derivative stockholders' suits has been superseded by Rule 23 in the federal courts.

Moreover, in no event would the existence of Rule 23 have any materiality to the question here involved. The question is whether the New Jersey statute is of the kind which must be enforced in a federal court by reason of the constitutional distribution of federal and state powers. If

it is, no federal statute or rule can be invoked to supersede or eliminate the state statute.

**2. Even if the statute is held to be procedural in nature, it must be enforced by the District Court under its own Local Rule 15.**

Even if Chapter 131 did not create a substantial right and did not embody an important public policy of the State, it would still have to be enforced under the District Court's Local Rule 15, which provides as follows:

> "*Applicability of State Court Procedure.* In circumstances not provided for by the Federal Rules of Civil Procedure, or by these rules, the procedure and practice of the Courts of the State of New Jersey shall govern."

It is clear that the security for expenses and counsel fees required under Chapter 131 of the New Jersey Laws of 1945 is a circumstance not provided for by the Federal Rules of Civil Procedure. It is likewise not provided for by the Rules of the District Court. While the latter Rules make provision, in Rule 12, for security for costs, that Rule relates only to security for costs required of non-residents, and, morever, contemplates security for ordinary costs only, whereas it is well settled in the Federal Courts that the expenses and counsel fees referred to in Chapter 131 are not "costs".

*Missouri State Life Insurance Co.* v. *Jones,* 290 U. S. 199 (1933);
*Springstead* v. *Crawfordsville State Bank,* 231 U. S. 541 (1913).

The law is well established that rules of court, unless directory and merely for the protection of the court, have the force of law and a federal court has no power to suspend

or modify retroactively any rule which it has made. Thus, it was held in *Rio Grande Irrigation and Colonization Co.* v. *Gildersleeve*, 174 U. S. 603 (1899), that a court rule fixing the time limit for motions to set aside a judgment rendered in vacation could not be dispensed with by the trial court. This Court quoted with approval the following passage from *Thompson v. Hatch*, 3 Pick. 512 (Mass., 1827):

> "A rule of the court, thus authorized and made has the force of law, and is binding upon the court as well as upon parties to an action, and cannot be dispensed with to suit the circumstances of any particular case * * *. The courts may rescind or repeal their rules, without doubt; or, in establishing them, may reserve the exercise of discretion for particular cases. But the rule once made without any such qualification must be applied to all cases which come within it, until it is repealed by the authority which made it."

Accord:

*Weil* v. *Neary*, 278 U. S. 160 (1929);
*Hicks* v. *Bekins Moving & Storage Co.*, 115 F. 2d 406 (9th Cir. 1940);
*Wise* v. *Herzog*, 114 F. 2d 486, 490 (D. C. Cir. 1940);
*In re G. W. Giannini, Inc.*, 90 F. 2d 445 (2d Cir. 1937);
*Superior Fire Insurance Co.* v. *Martin*, 80 F. 2d 275 (7th Cir. 1935), cert. denied 298 U. S. 672 (1936);
*In re Growe Construction Co.*, 253 Fed. 981 (N. D. N. Y. 1918).

Cases dealing with a question very similar to the one here before the Court have been decided in the Eastern

District of New York. Local Civil Rule 45 of the Eastern District of New York, *infra*, p. 93, provides in substance that in the absence of Federal law the District Court shall apply the procedure prevailing in the New York state courts. Since the United States District Court for the Eastern District of New York does not have a local rule dealing with security for costs required of non-residents, it has held that Local Civil Rule 45 requires the application of the state law governing such security.

> *De Rosmo* v. *Feeney*, 38 F. Supp. 834 (E. D. N. Y. 1941).

And under Local Civil Rule 45 so construed, the District Court for the Eastern District of New York has further held that the granting of an order for security for costs is mandatory and not discretionary.

> *Janssen* v. *City of New York*, 42 F. Supp. 380 (E. D. N. Y. 1941).

Finally, in *Donovan* v. *Queensboro Corp., supra*, the court, in applying the state statute under the doctrine of *Angel* v. *Bullington*, recognized that in any event it would have to be given effect under Local Rule 45, saying (75 F. Supp. at p. 133):

> "Moreover, Rule 45 of this Federal District Court provides that, 'whenever a procedural question arises which is not covered by the provision of any statute of the United States or of the Federal Rules of Civil Procedure * * * the procedure which shall then prevail in the Supreme Court of the State of New York shall be applied.'"

It should be pointed out that the District Court for the Southern District of New York, which decided the case of

*Boyd* v. *Bell*, does not have any local rule making it *mandatory* to apply the state procedure, as is required by Rule 15 of the District Court for the District of New Jersey.

It follows that Rule 15 of the Rules of the District Court governs and requires the application of the provisions of Chapter 131, if that statute is held to be "procedural" under the rule of *Erie R. R.* v. *Tompkins*.

## IV.

**There is no substance to the contention that the statute is unconstitutional.**

Petitioners attack the New Jersey statute as violating the due process, equal protection, contract and full faith and credit clauses of the Constitution.

What concretely is the nature of petitioners' right to which the statute applies? Petitioners, representing less than 0.0126% of the stock of the respondent corporation, are prosecuting an action for the alleged benefit, not of themselves, but of the respondent. If the action is unmeritorious, the respondent will be subjected to damage estimated to be at least $125,000; and there is absolutely no means by which the holders of the other 99.9% of its stock could make their judgment as to whether the bringing of the action was in the best interests of the corporation prevail over the ideas of petitioners holding less than 0.0126% of its stock.

However, it is said, perhaps petitioners will recover a substantial judgment and benefit the respondent and the holders of the other 99.9% of its stock. But the fundamental question here is whether it is a principle of constitutional law that the holders of 99.9% of the stock and their corporate management are *compelled;* contrary to the

policy of a State Legislature, to rely upon the responsibility and judgment of the holders of 0.0126% of the stock. In that connection, petitioners did not hesitate to plead causes of action alleging liability of over $90,000,000 which were so completely lacking in substance that they were stricken by the District Court as being insufficient even under the liberal rules of Federal pleading, but not before petitioners had caused substantial expense which must eventually be borne by respondent. See *Cohen* v. *Beneficial Industrial Loan Corporation*, 69 F. Supp. 297 (D. N. J. 1946).

Perhaps a better statute could have been drafted by the New Jersey Legislature to cope with the evil found (and admitted) to exist. There is no perfect solution for the problem involved. There never is in balancing a network of complicated relationships in modern corporate enterprise. Possibly giving the holders of an infinitesimal percentage of the stock of a corporation, instead of the minimum interest required by the statute, a free hand to prosecute derivative actions might make the difference as to whether some faithless officers are brought up to account. Perhaps some legislative changes are needed in the light of modern conditions to make corporate management more responsive to the will of the majority of the stockholders. But the question is whether the problems involved are matters coming within the area for legislative action or the area for judicial control under the Constitution.

We submit that the New Jersey statute must be upheld under the principle which this Court has consistently applied, namely, it is sufficient if the statute has a rational relation to the evil found by the Legislature to exist, that the forum for a consideration whether the statute be ill-considered or unwise is the Legislature which adopted it, and every possible presumption will be made in favor

of the validity of the legislative action. Thus, in *Daniel v. Family Security Life Insurance Co.*, 69 Sup. Ct. 550, 553 (1949), this Court said in upholding a South Carolina statute outlawing so-called funeral insurance:

> "We cannot say that South Carolina is not entitled to call the funeral insurance business an evil. *Nor can we say that the statute has no relation to the elimination of those evils.* There our inquiry must stop." (Italics supplied.)

Similarly, in *Zahn v. Board of Public Works*, 274 U. S. 325, 328 (1927), this Court said:

> "The most that can be said is that whether that determination was an unreasonable, arbitrary or unequal exercise of power is fairly debatable. In such circumstances, the settled rule of this court is that it will not substitute its judgment for that of the legislative body charged with the primary duty and responsibility of determining the question."

In *Olsen v. Nebraska*, 313 U. S. 236 (1941), this Court upheld a state statute fixing the maximum compensation which a private employment agency might collect from an applicant for employment. This Court rejected the argument that the statute was unconstitutional because there had been no showing that there were conditions which the Legislature might reasonably believe would injure the public unless corrected by such legislation, saying (p. 246):

> "We are not concerned, however, with the wisdom, need, or appropriateness of the legislation. Differences of opinion on that score suggest a choice which 'should be left where * * * it was left by the Constitution—to the States and to Congress.' * * * There is no necessity for the state to demonstrate before us that evils persist despite the competition which attends the bargaining in this field."

In sustaining the constitutionality of a New York statute attacked as violating the due process clause, this Court said in *Nebbia* v. *New York*, 291 U. S. 502, 538 (1934), that

> "every possible presumption is in favor of its validity * * *."

When the above principles are applied to the New Jersey statute, it is apparent that there is no substance whatever to the contention that it is unconstitutional; and that the proper forum for the petitioners to present their criticism is the New Jersey Legislature.

Thus, the Legislature and Governor of New Jersey expressly found that a substantial evil existed which called for correction. In adopting Chapter 131, the New Jersey Legislature found that the prosecution of stockholders' derivative actions *"has been the subject of great abuse and malodorous scandal"* (R. S. Cum. Supp. 1945/1947, p. 824). (Italics ours.) In approving the statute in question, the Governor of New Jersey pointed out that

> "These suits involving the highly complicated transactions of modern corporate business are very costly to defend, regardless of whether or not they may be justifiable. For this reason they have been the subject of great abuse and have been used to harass corporate officers and directors with baseless litigation. * * * It is a minimum protection for corporations, and their officers and directors, against 'strike suits' * * * " (R. 45).

Further, by adopting the statute, the Legislature and Governor of New Jersey found that the remedy selected was appropriately related to the correction of the evil found to exist. The extent of the evil which was involved and the relationship of the statute to the correction of that evil is well indicated by the fact that four other states have passed

similar statutes, New York (General Corporation Law, § 61-b), Pennsylvania (Pa. Stat. Ann. (Purdon, Supp. 1945) Tit. 12, § 1322), Maryland (Md. Laws, 1945, ch. 989) and Wisconsin (Wis. Stat. (1945) § 180.13). This Court in *Daniel* v. *Family Security Life Insurance Co., supra,* recognized the fact that the enactment of similar statutes by different states showed that there must be some reasonable basis for the type of statute adopted. In upholding the South Carolina statute, this Court said (69 Sup. Ct. at p. 552):

> "The South Carolina legislature is not alone in seeing evils in this kind of insurance, and in invoking its police powers to combat them." [Reference to the laws of New York, Florida, Ohio and Maryland omitted.]

It was upon the basis of the above principles that the New York Court of Appeals upheld the constitutionality of the New York statute, substantially identical with the New Jersey statute here involved, in *Lapchak* v. *Baker,* 298 N. Y. 89, 95, 80 N. E. 2d 751, 753 (1948), saying:

> "The existence of some of these evils is here conceded. Moreover, the Legislature, *as we must assume,* inquired and found (1) justification for making special provision in respect of derivative suits brought by holders of relatively small amounts of a corporation's stock and (2) occasion for requiring plaintiffs in such suits to give reasonable security for litigation expenses of defendants therein. [Citations omitted.] Of course, it is not for us to question the wisdom of the choice of remedy here adopted by the Legislature." (Italics supplied.)

The briefs submitted to the New York Court of Appeals in that case to support the claim of unconstitutionality

contained the same arguments, almost verbatim, as are contained in the briefs submitted to this Court in support of petitioners' position; and they were all rejected.

In the light of the above principles, it becomes apparent why the New York Court of Appeals unanimously rejected such arguments on the basic ground that the criticisms involved were a matter for legislative and not judicial consideration. However, we shall now proceed to discuss the alleged application of each of the clauses of the Constitution invoked by the petitioners.

We will show (A) the statute does not violate the due process clause, (B) the statute does not violate the equal protection clause, (C) the application of the statute to actions pending at the time of its enactment does not violate either the contract or due process clause, and (D) the statute does not violate the full faith and credit clause.

## A.

## The Statute Does Not Violate the Due Process Clause.

The petitioners contend in substance that (1) the due process clause guarantees to a stockholder a right to prosecute a derivative action and (2) the statute deprives petitioners of such right without due process of law. We will deal with these contentions in the same order.

### 1. The due process clause does not guarantee to a stock holder a right to prosecute a derivative action.

This is so because of two reasons: (a) The right to bring a derivative action is not property within the meaning of the due process clause, and (b) even if it were property, the right to prosecute an action may be barred under the police power of a state.

(a)

While we shall show below under sub-point 2, pages 49-63, that, even if a right to prosecute a derivative action were a property right, the statute clearly does not take away that right without due process of law, we shall show here that it is not a property right within the meaning of the due process clause.

The petitioners' position is predicated upon the fallacious assumption that the right of a stockholder to prosecute a derivative action is the same as the right of a plaintiff to prosecute a cause of action which is his own property. Thus, in asserting an unconstitutional denial of access to the courts, petitioners rely exclusively upon cases dealing with a party enforcing his *own* cause of action and his *own* property rights.

However, it is well established that a stockholder in a derivative action is prosecuting not his own cause of action but that of the corporation; and that such cause of action is the property of the corporation and not the property of the plaintiff stockholder. The applicable law was expressed as follows by the court below (R. 58):

> "The right to bring a stockholder's derivative suit is not a property right and as this court held in Overfield v. Penroad Corporation, 146 F. 2d 889, 894 . . . the individual stockholder is permitted to sue 'simply in order to set in motion the judicial machinery of the court.'"

It is a basic principle of the law of corporations that stockholders have no property right in the assets of their corporation. As stated by Mr. Justice Holmes in *Klein* v. *Board of Supervisors*, 282 U. S. 19, 24 (1930):

> "But it leads nowhere to call a corporation a fiction. If it is a fiction it is a fiction created by law with in-

tent that it should be acted on as if true. *The corporation is a person and its ownership is a nonconductor that makes it impossible to attribute an interest in its property to its members.*" (Italics ours.)

This Court said in *Koster* v. *Lumbermens Mutual Casualty Co.*, 330 U. S. 518, 522 (1947):

> "The cause of action which such a plaintiff brings before the court is not his own but the corporation's. It is the real party in interest and he is allowed to act in protection of its interest somewhat as a 'next friend' might do for an individual, because it is disabled from protecting itself."

In the recent case of *Myer* v. *Myer*, 271 App. Div. 465, 473, 66 N. Y. S. 2d 83, 91 (1st Dept. 1946), aff'd 296 N. Y. 979, 73 N. E. 2d 562 (1947), the rule is stated as follows:

> "A stockholder has no right to institute action in his own behalf, but only on behalf of the corporation.
>
> * * * * * *
>
> "The right that the plaintiffs have * * * to sue in the name of and for the benefit of the corporation * * *, is a contingent right of action only. Insofar as it may be of benefit to the stockholder personally the property right is a remote and insubstantial one * * *. *Under these circumstances we do not deem the right is one that may demand protection against legislative regulation* * * *. The situation might be different if the stockholder had a right of personal recovery against the officers and directors and was prevented from pursuing his remedies as a creditor as to some accrued claim. * * *
>
> "Here the corporation was the creditor and its rights remained unabridged." (Italics ours.)

The New Jersey Court of Chancery in *Goodbody* v. *Delaney*, 80 N. J. Eq. 417, 419, 83 Atl. 988, 989 (Ch. 1912), has expressed the same view as follows:

> "The stockholders do not sue in their own right, but in the right of the corporation, and the use of the names of stockholders as complainants is mere procedure and belongs not to the substantive law of the case, but to the pursuit of the remedy in favor of the corporation."

Despite the well established law referred to above, petitioners would have the constitutional issues which they tender in this case decided just as if the cause of action prosecuted by a plaintiff in a derivative action were his own property. In this connection, they assert that a derivative action represents a stockholder's "only effective remedy against corporate abuse" and that nothing turns on the technical name which is given to the nature of the remedy involved.

However, such fundamental distinctions as to who really owns a cause of action and whose property is really involved cannot be so lightly brushed aside, especially when the basic problem is to distinguish between the area for legislative action on the one hand and the area for constitutional restrictions on the other. So far as this problem is concerned, what then is the important difference between a plaintiff prosecuting his own cause of action and a stockholder prosecuting an action owned by his corporation? In the first case, the plaintiff is acting solely on his own behalf, and in the second case the stockholder is acting on the behalf of the corporation and the vast majority of the other stockholders and without their consent or approval. In the first case, it is only the property of the plaintiff that is involved, and, in the second case it is the property of the corporation as a

whole and the interest which *all* of its stockholders have therein that is involved.

It thus follows that since the New Jersey statute deals with the property rights of the corporation as a whole, the only constitutional issue which could be involved is whether the New Jersey statute has deprived *corporations* of their property in an arbitrary or unreasonable manner. To state the real issue involved is to disclose the obvious answer. For very good reasons, petitioners do not seriously contend that the statute has arbitrarily and unreasonably deprived the *corporation* of property. For once it is observed that such is the basic problem, it becomes apparent that a legislative and not a judicial field is involved.

(b)

Moreover, even if a cause of action *owned* by a stockholder were involved (which as shown above is not the case) and even if the New Jersey statute had unconditionally barred such an action (which it has not), the due process clause would not, merely for those reasons, make the action of the New Jersey Legislature invalid. A state may prohibit the prosecution of such an action in its courts, provided such prohibition has a reasonable relation to a public evil and does not involve any unreasonable classifications.

Thus, in *Pittsburg Steel Co.* v. *Baltimore Equitable Society*, 226 U. S. 455 (1913), this Court upheld the constitutionality of a state statute outlawing the pre-existing right of one creditor of a corporation to recover against stockholders on their subscription obligations to the corporation. In *Battaglia* v. *General Motors Corp.*, 169 F. 2d 254 (2 Cir. 1948), cert. denied 335 U. S. 887 (1948), a statute outlawing the pre-existing right of an employee to maintain a so-called portal-to-portal action to recover

compensation was upheld. In *Veix* v. *Sixth Ward Association*, 310 U. S. 32 (1940), a state statute outlawing a pre-existing right of a shareholder in a New Jersey building and loan association to recover his investment upon 30 days' notice was upheld. In *Gelfert* v. *National City Bank of New York*, 313 U. S. 221 (1941), this Court upheld a state statute outlawing a pre-existing right of a mortgagee to recover a deficiency judgment equal to the difference between the amount of the debt and the amount for which the mortgagee bought in the property at a foreclosure sale.

**2. In no event does the statute deprive a stockholder of any right without due process of law.**

The statute does not prohibit the prosecution of derivative actions, but merely subjects the prosecution of such actions to reasonable conditions which represent a remedy that has a reasonable relation to the evil found to exist.

It is clear that (a) New Jersey provided a remedy for a serious evil where no remedy existed before; (b) the particular remedy selected by the Legislature had a reasonable relationship to the correction of the evil; and (c) the statute merely made the prosecution of derivative actions subject to reasonable conditions.

**(a)**

**New Jersey Provided a Remedy for a Serious Evil Where No Remedy Existed Before.**

As we have pointed out above, the petitioners would overlook the anomalous legal situation which resulted from the uncontrolled prosecution of stockholders' derivative actions because of a fallacious assumption that they are comparable to an ordinary litigation in which the plain-

tiff and defendant are concerned solely with their own individual rights and duties.

As distinguished from an ordinary litigation, in a stockholder's derivative action the rights and interests of third parties are involved. The extent to which the plaintiff's own individual rights are *indirectly* involved represents only an insignificant fraction of the total rights which are *directly* involved.

When a plaintiff in a normal litigation brings an action, he subjects no one to a risk of loss other than himself and the defendant from whom he seeks recovery. In sharp contrast, when a stockholder institutes a derivative action, he subjects third parties (whose interests far outweigh the interest of the plaintiff stockholder and who are charged with no wrong-doing) to a risk of loss. The nature of the evil involved has been stated as follows in the *Survey and Report regarding Stockholders' Derivative Suits* by Franklin S. Wood (pp. 20-21):

> "To permit a stockholder with a few shares of stock to institute such a derivative action ostensibly in behalf of the corporation but actually in the interest of his attorney, since the latter alone stands to profit in any substantial degree from it, without any responsibility for costs of the action if shown to be unfounded is, to paraphrase Judge Rosenman's language in a bondholders' action for an accounting, tantamount to allowing him and his attorney to gamble with other peoples' money. Section 130-f of the Real Property Law, enacted in 1936, no longer permits such a free gamble by a bondholder and it would seem that less excuse can be found for permitting it in the case of a stockholder, whose initial investment and interest in the outcome are frequently much less than that of a bondholder."

Even if there were no record of experience by which to measure the extent of the evil involved, the probability of abuse in the uncontrolled prosecution of derivative actions would be indicated by a fair answer to the question: What motivation does a stockholder have in prosecuting a long-drawn out and expensive corporate litigation when his economic interest in the outcome of the litigation represents only a few dollars?

It is incredible that in the great majority of cases the plaintiff is motivated by a consideration of the effect of the litigation on the welfare of the corporation.

It is not necessary, however, to rely merely upon logic, for experience has shown the extent to which the prosecution of this type of action has been abused and the extent to which corporations have been injured thereby.

Some of the abuses connected with the prosecution of derivative stockholders' suits have recently been described by Richard F. Wolfson, a member of the law firm of Kurland & Wolfson, New York City, and a partner of petitioners' counsel here, in an article entitled "Striking out 'strike suits'" in the March, 1949 issue of "Fortune," as follows (at p. 138):

> "The latter [abuses other than blackmail] may, indeed, be inherent in derivative stockholder suits. They arise chiefly from the fact that lawyers, not plaintiffs, are financially interested in bringing derivative actions. For example, in a stockholder action brought on behalf of Paramount Pictures, one plaintiff stood to gain only 17 cents per share by appreciation of the value of his stock. Such a plaintiff is unlikely to ask a lawyer to institute on his behalf an expensive, time-consuming suit. Even less likely is he to pay the costs.

"But the lawyer may get a sizable fee because derivative stockholder actions work on a contingent principle * * *

* * * * * * *

"* * * This disparity between the plaintiff's and his lawyer's interest has led to a species of what lawyers quaintly call 'champerty and maintenance.' A lawyer discovers a derivative cause of action, solicits a stockholder as client, pays expenses, and, for the use of his name, offers the client a small share of any fees recovered. For many lawyers the search for clients is no haphazard affair; and arrangement is made with a broker to furnish them.

* * * * * * * *

"Another unfortunate product of stockholder actions is the waste of time and money involved in unsuccessful ones. Because such suits often involve difficult and novel questions of corporation law and intricate factual situations, months or years are spent in court. Expenses mount, as do attorneys' fees of individual defendants. If the suit fails, the expenses and fees are generally borne by the corporation, as ordered by the bylaws."

In an article entitled "Directors Who Do Not Direct", 47 Harv. L. Rev. 1305 (1934), Professor (now Mr. Justice) William O. Douglas said (at p. 1327):

"The enforcement of these obligations of trusteeship has two aspects. In the first place, there is the small and isolated investor who needs adequate opportunity for protection against the managers or the board. In the second place, there are the managers and the board who need effective protection against the blackmailer or striker, lest the risks attendant to those business positions prove to be too onerous. Making it easier for the legitimate plaintiff and harder for the illegitimate is a problem which will

never be wholly solved, but some progress can be made. In one form or other it means granting to trial courts greater discretion. * * * *And it certainly would embrace a reconsideration of the control over costs or security for costs.*" (Italics added).

The following is a typical comment by the courts:

In *Gazan* v. *Vadsco Sales Corporation*, 6 F. Supp. 568 (E. D. N. Y. 1934), the court said:

> "The plaintiff testified that he had never read the complaint, did not know what it contained; and was unaware of the charges made over his name in the complaint against the defendant corporation; that he had not contributed to the expenses of the litigation; that he did not know of any of the information that was contained in the complaint, nor did he give such information to the plaintiff's attorney, nor did he know in what manner his counsel obtained the information for the purposes of preparing the complaint.
>
> "Apparently the plaintiff gave the use of his name to others for the purpose of instituting this action. This action was brought without any basis, and was vexatious and oppressive. It was brought solely for the purpose of annoying and harassing the defendant corporation and its business."

The seriousness of the damage inflicted upon corporations as a consequence of unsuccessful stockholders' actions is discussed as follows in Wood, *Survey and Report Regarding Stockholders' Derivative Suits* (1944) 8:

> "Cost of Stockholder Litigation to Public:
>
> * * * * * *
>
> "The direct cost of defense to the corporations involved has also been substantial. Since many defendants are usually involved, numerous separate

defense counsel are often necessarily employed, the tabulated cases showing 296 actions in which three or more defense counsel appeared. Allowances to attorneys for individual defendants under §61-a of the General Corporation Law in twelve recent actions, ranging from $4,000 to $135,000 are given below, and judgments of dismissal in two other cases currently on appeal provide for such allowances. These are exclusive of fees paid counsel for the corporations involved, of which there is no court record, although in two reported instances such fees exceeded $100,000 (*Kirby* v. *Schenck*, 25 N. Y. S. 2d 431; *Heller* v. *Boylan*, 29 N. Y. S. 2d 653)."

(b)

**The Particular Remedy Selected by the Legislature had a Reasonable Relation to the Correction of the Evil.**

The weakness of the claim that the remedy adopted by the Legislature has no rational relation to the evil involved is well indicated by the fact that the briefs submitted in support of that claim resort to an attack on the motives of the Legislatures of New Jersey and New York.

Instead of according to the State Legislatures "every possible presumption" in favor of their action, and asking the question as to whether there was any reasonable basis on which the Legislature could have adopted the remedy involved, the petitioners would reverse the process and require the Legislature to prove that there could be no reasonable basis on which anyone could have opposed the legislation in question.

Let us consider the question involved in the light of the correct principle of constitutional law, namely, is there any reasonable basis, in the light of the evil involved, on which the Legislature could have selected the remedy which it did select.

The Legislature did not prohibit the prosecution of derivative actions which, as above shown, it could have constitutionally done; instead it permitted the continued prosecution of such actions, provided not merely one but any one of three conditions were met.

In the first place, if a stockholder could enlist the support of the holders of 5% of the outstanding stock of a corporation, a derivative action could be instituted without any restrictions and without the necessity of putting up security. This still permitted 5% of the stockholders to override the judgment of 95% with respect to the wisdom of corporate litigation. But the Legislature recognized that in large corporations, with their stock widely held, a substantial burden (but not unreasonable in the light of the evil involved) would be placed on a small stockholder to enlist the necessary support, and so

In the second place, the Legislature provided that if a stockholder could enlist the support of the holders of stock which had a market value of $50,000, a derivative action could be instituted without any restriction and without the necessity of putting up security. Under this alternative, as the corporation gets larger the percentage of the stock ownership required gets smaller. For example, in the case of a corporation whose outstanding stock has a market value of $50,000,000, a derivative action can be prosecuted without restriction by holders of only 1/10 of 1% of the stock. And the attack on the statute is directed to its impact on a stockholder in the large corporations with their stock widely held by the general public.

However, petitioners assert that even this relaxation of the statutory requirements, embodied in the second alternative, is unreasonable. The question is whether requiring a small stockholder to enlist the support of holders of

1/10 of 1% or 1% and so on of the corporation's stock, depending upon the size of the corporation, imposes an arbitrary burden which has no rational relation to the evil involved.

No doubt the requirement would increase the burden of instituting a derivative action. But it is an unsupportable assertion to say that it is unreasonable. Generally, of course, it is the lawyer who in the first instance enlists the support of a small stockholder. The method that he uses in enlisting the support of one small stockholder is the same method by which he can enlist the support of a few more stockholders. In that connection access can be obtained to the stock books of the corporation and in these large corporations with their stock widely held it is more than probable that numerous other small stockholders will reside within a distance making it inexpensive to have a personal discussion with regard to the merits of the action which is desired to be instituted.

Moreover, in the case of large publicly owned corporations with which petitioners are concerned, a stockholder is permitted under the regulations promulgated under the Securities Exchange Act of 1934 to require the corporation to print and circularize in its proxy statement without expense to him proposals which he desires to submit to the stockholders. See Regulation X-14, Rule X-14A-8.

The petitioners assert that fewer derivative actions have been instituted since the adoption of the statute, but for all the petitioners can show this is due to the fact that it is difficult to find more than one or two persons in each corporation who is willing to lend his name to questionable litigation.

It is said that prior to the enactment of these statutes some meritorious actions were instituted by a stockholder

holding only a few shares of stock; and that these meritorious actions will be struck down by the statutes along with the groundless and abusive litigations. That again is an unsupportable assertion. Before the enactment of these statutes it was unnecessary for a stockholder owning only a few shares of stock to persuade additional stockholders to join as plaintiffs; and hence there is no basis for saying that if they had made such an effort with respect to *meritorious* litigations they would have failed. It is unreasonable to assume that there is only one stockholder in each corporation owning a few shares who alone occupies the unique position of being able to recognize the need for the prosecution of a meritorious action. It is unreasonable to assume that there is only *one* of such stockholders who has a unique access to the facts to enable a determination as to whether or not a meritorious claim exists. And the second, third and fourth stockholders would have no greater risk to assume than the first stockholder, which is absolutely nothing, provided the attorney takes the case on a contingent basis, which is the usual practice. The fact of the matter is that in the past lawyers have not desired to inform other stockholders of a proposed derivative action in order to eliminate the risk of having to share the eventual fee with other lawyers.

Finally, it should be pointed out that Rule 23(b) of the Federal Rules of Civil Procedure requires a stockholder, before instituting a derivative action, to present the facts to not merely a very small percentage of the stockholders, but the majority of the stockholders, unless he can affirmatively show special circumstances which would make such a presentation futile. It has been held that difficulties in communicating with the stockholders do not excuse compliance with this requirement. *Stone* v. *Holly Hill Fruit Products*, 56 F. 2d 553, 554 (5th Cir. 1932); *Toebelman* v. *Missouri-Kansas Pipe Line Co.*, 41 F. Supp. 231, 239 (D. Del. 1941)

Petitioners make the extraordinary suggestion (on p. 27 of their brief) that the Legislatures which enacted these statutes were not really interested in giving a stockholder a right to qualify to prosecute a derivative action by enlisting the support of additional stockholders. They do this on the basis of an assertion that certain New York cases have held that "the joinder, *after* an action has been commenced, by plaintiffs owning at least the minimum amount of stock required by the statute does not obviate the necessity for the security . . ." (Italics ours.) In fact, these cases (cited on p. 28 of petitioners' brief) hold the contrary. They decided that a stockholder might qualify by enlisting the support of other stockholders even after the commencement of the action.

In the third place, if and only if a stockholder cannot qualify under either of the two alternatives referred to above, is he required to put up security to protect the corporation and the vast majority of its stockholders against loss. He is required to put up security in a reasonable amount; and it is left to the trial court in each instance to determine in its discretion what is a reasonable amount. There is of course no doubt that the requirement for security has a relation to the evil involved, for it goes to the essence of protecting corporations and their stockholders against the type of losses to which the Legislature has found they have been subjected. But the petitioners protest that the smaller stockholder will be unable or unwilling to put up the security. This may be true; but the statute could not possibly become more restrictive on the right of a small stockholder to prosecute a derivative action because he is given an additional, i. e., a third, alternative basis for qualifying to prosecute a derivative action. And how can it be claimed that it was unreasonable for a Legislature to prevent the institution of litigation involving the whole cor-

poration, unless 1/10 of 1% or 1% or a maximum of 5% of the stockholders determine that such litigation should be instituted.

If the Legislature had any right to require certain conditions to be met as a safeguard against the prosecution of abusive derivative actions (and it obviously did), *any* safeguards which it adopted that had any meaning would necessarily inhibit the institution of derivative actions. But apparently it is the contention of the petitioners that the Legislature had no power to impose any conditions so far as the *institution* of a derivative action is concerned, but was required to adopt some kind of remedy which would apply to the handling of the litigation *after* it was instituted.

Thus they suggest that the Legislature should have adopted a statute abolishing so-called "secret settlements". No doubt legislation against "secret settlements" would serve a good purpose, but that would fall far short of remedying the type of evil with which the New Jersey Legislature was concerned. The parties defendant would have the same desire to avoid the great expense and harassment incident to litigation; and the instigators of strike-litigation would know full well that such desire would exist. After an offer of settlement to avoid these results, a court has no basis on which to disapprove the settlement of an unmeritorious action, for it does not have the time or the facilities to make an investigation of the facts that lie behind the agreed settlement. And, contrary to the expectations of the plaintiff-stockholder, a settlement may not be forthcoming. In that event the plaintiff will either have to go through with his groundless litigation or to abandon it at some stage. In either case the corporation would be left to bear the expense and damage which had been caused.

There is no adequate basis for stopping the evils incident to derivative actions except by the adoption of adequate conditions to the institution and prosecution of such actions. In any event, it cannot be justifiably asserted that the Legislature of New Jersey could not reasonably so believe.

(c)

**The statute merely made the prosecution of derivative actions subject to reasonable conditions.**

While, as we have shown above (pp. 44-49), New Jersey could have unconditionally prohibited derivative actions in view of the evils found to exist, the New Jersey statute merely imposes conditions which, in the light of the circumstances referred to above, pp. 50-59, are certainly not arbitrary or unreasonable.

The power of the Legislature to subject the prosecution of actions to conditions precedent cannot be questioned. In *Jones v. Union Guano Co.*, 264 U. S. 171, 181 (1924), this Court held that

> "The Fourteenth Amendment does not prevent a State from prescribing a reasonable and appropriate condition precedent to the bringing of a suit of a specified kind or class so long as the basis of distinction is real, and the condition imposed has reasonable relation to a legitimate object."

For very good reasons, the petitioners do not refer to any authorities which have even a remote bearing on the reasonableness of the first two alternatives under which a stockholder may qualify to prosecute a derivative action, namely, enlisting the support of the required percentages of stock ownership. And if these alternatives represent reasonable conditions, the presence of a third alternative, even if unreasonable, could not possibly invalidate the statute.

Moreover, petitioners do not refer to any cases which support their assertion that the requirement of security is an unreasonable condition. They refer exclusively to cases dealing with conditions applicable to the enforcement by a party of a cause of action which is his own property. But what may be unreasonable in such a case can be entirely reasonable where the plaintiff undertakes to enforce the property rights of others and subjects them to a risk of loss.

Further, this Court has consistently held that it is reasonable and constitutional to condition the prosecution of a cause of action on the assumption of liability for the adversary's reasonable counsel fees.

*Life & Casualty Co.* v. *McCray*, 291 U. S. 566 (1934);

*Dohany* v. *Rogers*, 281 U. S. 362 (1930);

*Sioux County* v. *Nat. Surety Co.*, 276 U. S. 238 (1928);

*Missouri, Kansas & Texas Ry.* v. *Cade*, 233 U. S. 642 (1914).

In *Life & Casualty Co.* v. *McCray*, *supra*, Mr. Justice Cardozo, speaking for the Court, said (at p. 569):

> "There are systems of procedure neither arbitrary nor unenlightened, and of a stock akin to ours, in which submission to such a burden [the adversary's counsel fees] is the normal lot of the defeated litigant. * * *. The assurance of due process has not stereotyped bills of costs at the rates known to the Fathers."

In *Dohany* v. *Rogers*, *supra*, the Court said (at p. 368):

> "A state may allow the recovery of an attorney's fee in special classes of proceedings while withholding them in others."

With respect to conditioning the prosecution of an action on the posting of security, it has even been held by this Court that the enjoyment and use of one's own property may be conditioned on putting up security.

Thus, in *Gant* v. *Oklahoma City*, 289 U. S. 98 (1933), a city ordinance was involved which provided that no oil well should be drilled within the city limits until there should be filed with the city clerk a bond in the sum of $200,000 covering each well. The plaintiffs alleged that they had contracted for drilling on their land and that the work had begun and was in progress, but that the city threatened to forcibly stop the work unless they executed a bond in the sum of $200,000, and contended that the ordinance was unreasonable and unconstitutional, and if enforced would have the effect of depriving them of valuable property rights without due process of law. However, Mr. Justice Sutherland, speaking for a unanimous court, had little difficulty in rejecting these contentions. He said (at p. 101):

> "In view of the peculiar dangers incident to the drilling and operation of an oil or gas well within the limits of a city and of the large interest involved if the well be successful, neither the requirement for a bond nor the amount fixed can be declared arbitrary or unreasonable."

Referring to appellees' allegation that they were unable to furnish the bond, Mr. Justice Sutherland said (at p. 102):

> "Whether the judgment of the common council of the city in the present case was wise, or whether the requirement will produce hardship in particular instances, are matters with which this court has nothing to do. It is impossible for us to say that the provisions of the ordinance are clearly arbitrary and unreasonable. If there be room for fair debate,

this court 'will not substitute its judgment for that of the legislative body charged with the primary duty and responsibility of determining the question.' * * * The fact that appellants, for reasons peculiar to themselves, could not meet the imposed requirements does not militate against the constitutionality of the ordinance. * * * An otherwise valid statute or ordinance * * * is not rendered invalid merely because it chances that particular persons find it hard or even impossible to comply with precedent conditions * * *."

It is submitted that this case is decisive of the due process point here involved. This Court there upheld the requirement of posting security as a condition precedent to the use by a person of his own property, where such use involved a risk of loss and damage to others. *A fortiori* it must be permissible to subject the bringing of a derivative stockholders' action to such a condition precedent, where the stockholder does not assert his own property rights, but merely acts as an instigator for the protection of the corporation's property rights, and where loss and damage will be inflicted on the corporation if the action is unsuccessful.

**B.**

**The Statute Does Not Violate the Equal Protection Clause.**

In attacking the classification adopted by the New Jersey Legislature as violating the equal protection clause, the petitioners resort to the same method employed in connection with their attack under the due process clause. They again attack the motive of the Legislature and attempt to shift the burden to the Legislature to show that there was no basis on which any person could reasonably disagree with the classification adopted by it.

However, the classification used by the New Jersey gislature must be upheld unless it is clearly shown that can be supported on no rational basis. In view of the t that this is a statement of an old established principle constitutional law, no extended discussion is called for d we will merely refer to two decisions by this Court in ich the legal point involved has been unequivocally ablished.

In *Lindsley* v. *Natural Carbonic Gas Co.*, 220 U. S. 61, (1911), the Court said:

> "The equal protection clause of the Fourteenth Amendment does not take from the State the power to classify in the adoption of police laws, but admits of the exercise of a wide scope of discretion in that regard, and avoids what is done only when it is without any reasonable basis and therefore is purely arbitrary. * * * When the classification * * * is called in question, if any state of facts reasonably can be conceived that would sustain it, the existence of that state of facts at the time the law was enacted must be assumed."

In *Clark* v. *Paul Gray, Inc.*, 306 U. S. 583, 594 (1939), Court's function in determining the validity of a statute der the equal protection clause is stated by Mr. Justice one as follows:

> "The classification * * * is a legislative, not a judicial, function. Its merits are not to be weighed in the judicial balance and the classification rejected merely because the weight of the evidence in court appears to favor a different standard. * * * The determination of the legislature is presumed to be supported by facts known to it, unless facts judicially known or proved preclude that possibility. * * * Hence, in passing on the validity of the present

> classification, it is not the province of a court to hear and examine evidence for the purpose of deciding again a question which the legislature has already decided. Its function is only to determine whether it is possible to say that the legislative decision is without rational basis."

Thus, it is wholly irrelevant to the constitutional law question raised to consider whether the Legislature acted wisely or whether the classification adopted has some defects or whether some other classification might have been adopted which would have been better. The only question is whether there was some rational basis for the classification which the Legislature did adopt.

A mere statement of the real issue involved discloses the contention of the petitioners to be without substance.

As shown above, the Legislature found that the prosecution of stockholders' derivative actions had "been subject to great abuse and malodorous scandal." This abuse had resulted from the prosecution of derivative actions by stockholders holding only a few shares of stock and having no real economic interest in, and no concern as to, the effect of the litigation on the welfare of the corporation.

An analysis of 1400 stockholders' derivative actions which were instituted during the ten-year period 1932-1942 shows that in the case of actions brought by holders of less than 5% of the stock only 2% of the actions were held to be meritorious. (Wood, *Survey and Report Regarding Stockholders' Derivative Suits* (1944) pp. 16, 30, *et seq.*) It is said that these figures do not show that a greater percentage of meritorious actions were instituted by those holding more than 5%. But against this pure speculation, it is admitted that practically all of derivative actions were instituted by persons holding only a few shares of stock.

The experience of the courts with abusive derivative suits instituted by stockholders owning merely a few shares of stock is illustrated by the following cases:

In dismissing a stockholders' suit, the court pointed out in *Hauben* v. *Morris*, 255 App. Div. 35, 37, 5 N. Y. S. 2d 721, 723 (1st Dept. 1938), aff'd 281 N. Y. 652, 22 N. E. 2d 482 (1939):

> "The suit was commenced in the latter part of 1934, a few days after the plaintiff Hauben had become a stockholder of record of sixteen shares of one dollar par value stock (at a cost to him of twenty-seven dollars) out of a total of $4,591,000 par value of stock outstanding".

In *Weinberger* v. *Quinn*, 264 App. Div. 405, 409, 35 N. Y. S. 2d 567, 572 (1st Dept. 1942), aff'd 290 N. Y. 635, 49 N. E. 2d 131 (1943), the court again stressed the important bearing of this factor when it said:

> "A stockholder's derivative suit may be a useful agency or it may be grossly abused for purposes far removed from any desire to do a service to the corporation represented. The prevalence of suits of the latter nature appears to have recently caused the Legislature to enact a statute requiring the corporation to pay the expenses of directors who are successful on the trial of this form of action. * * *
>
> "When we find a stockholder, owning fifty shares out of upwards of 7,000,000 shares, seeking to enforce alleged rights of his company, with the possibility of subjecting it to these large statutory costs and expense in the event of failure, we think it is the duty of the courts to require at least the statement of more than a mere general charge of wrongdoing before resort to equity may be had."

Again, in *Hayman* v. *Morris*, 36 N. Y. S. 2d 754, 764 (Sup. Ct., N. Y. Co., 1941), the court, in dismissing the complaint on the merits, said:

> "The defendants further claim that plaintiffs have not brought this action in good faith but that it was begun for other reasons and for personal gain to themselves and for others allied with them.
>
> "I might say at this stage that I am rather inclined to so view the bringing of this action when the actual benefits in dollars and cents which may accrue to plaintiffs and which they may derive from success of this litigation are considered, and it is somewhat difficult to believe that they have really brought this action also for the benefit of all the other stockholders who, to date, it appears, have evinced no desire to intervene or otherwise participate and whose holdings far exceed the meager holdings of the plaintiffs."

In *Clark* v. *National Linseed Oil Co.*, 105 Fed. 787 (7th Cir. 1901), the court found evidence of bad faith in the fact that the plaintiff stockholders owned 3% of the stock, saying (at p. 794):

> "These strictures upon the bill, as an affidavit, would be cogent, had all the stockholders, or a large proportion of them joined the appellants in their attack upon the president and directors; but they are still more cogent, when it is borne in mind that ninety-seven per cent. of the stockholders refuse such an affiance. Is it not probable that the ninety-seven knew, as well as the three, the details of these transactions? Is it probable that they would acquiesce in the misconduct alleged—misconduct so harmful to their interests? Under circumstances like these, there should be the clearest and most convincing presentation, in the affidavit, of the facts—each material one within the personal knowledge of the wit-

> ness—to justify the court in disregarding the judgment of the ninety-seven, in an effort to meet the wishes of the three."

In *Bookman* v. *R. J. Reynolds Tobacco Co.*, 138 N. J. Eq. 312, 409, 48 A. 2d 646, 700 (1946), the Court of Chancery quotes with approval from the unreported case of *Wallen* v. *Duro-Test* as follows:

> "Complainant seeks by this suit to establish rights of Duro-Test against the defendants, rather than his individual rights and in such a suit the motives of the complainant are a proper subject of inquiry. * * * Considering this complainant's infinitesimal proportionate interest in Duro-Test stock issue, it does not seem that he is moved solely by a desire to benefit other stockholders who decline to join in his attacks on the defendant's acts, but that an ulterior motive has prompted this suit."

Unless the New Jersey Legislature had desired to completely outlaw derivative actions or unless it desired to require security in all derivative actions, it had of necessity to make *some* classification. Indeed, if the New Jersey Legislature had made no classification at all, petitioners would have been the first to attack the statute, for they claim that the requirement of security is a practical equivalent of outlawing the action and that that is unconstitutional.

And yet the petitioners do not tell us what kind of classification they would have had the Legislature make. Apparently they take the position that the statute would have been unconstitutional if no classification had been made, and it would be equally unconstitutional if any classification had been made.

We will now show that the particular classification adopted by the New Jersey Legislature not only had a

rational relation to the evil involved, and thus fully met the constitutional requirements, but also that it was a wholly reasonable and fair classification in the light of the evil involved.

The evil which existed involved the instigation by lawyers of derivative actions in the name of a stockholder holding an insignificant fraction of the total stock of the corporation. The first requirement of a reasonable classification was that it must be aimed at this evil; and the classification adopted by the New Jersey Legislature was directly aimed at this evil.

Experience had shown that, while lawyers could find one or two stockholders in a corporation who were willing to have their names used in connection with questionable litigation, they would probably not find very many stockholders who would permit their names to be so used; and that while lawyers could find one stockholder having an insignificant fraction of the total stock of a corporation who would permit his name to be used in questionable litigation, they would probably not find one stockholder having a substantial interest in the corporation who would permit his name to be so used. And so the New Jersey statute made an appropriate classification to cover this entire situation.

In the first place, it provided that if a *number* of stockholders joined together who owned a maximum of 5% in the case of small corporations and a proportionately smaller percentage in the case of large corporations (for example only 1/10 of 1% in the case of a corporation whose outstanding stock has a market value of $50,000,000), an action could be prosecuted without any restriction or without putting up any security.

In the second place, it provided that if any *one* stockholder fulfilled the same requirements as to percentage of

total stock, he could prosecute a derivative action without any restrictions or without putting up any security.

It is difficult to see how the classification could have been more reasonable or fair. Surely no one would suggest that if 4 stockholders owning 1% of the stock could prosecute a derivative action without any restrictions or without putting up security, *one* stockholder owning the same percentage of stock should not have the same privilege, or vice versa. Surely no one would suggest that the statute was unreasonable because it did not require a *larger* percentage of stock ownership than it did. And surely no one would suggest that if it were appropriate for the Legislature to fix *any* minimum percentage of ownership, it was unreasonable to fix a percentage of 5% in the case of small corporations which generally are closely held or of progressively smaller percentages in the case of the large public corporations which, as above stated, amounts to only 1/10 of 1% in the case of a $50,000,000 corporation.

What arguments then are made in support of the petitioners' position?

First, it is argued that this classification discriminates against the poor in favor of the wealthy, and the Legislature is accused of being so motivated. The purpose of this argument is transparent and it has no validity whatever. The fact that one person owns one share of stock in a *particular* corporation and another owns 50 shares in that same corporation is no index of the comparative wealth of the two persons.

More than that, the purpose of this legislation is to protect the welfare of the corporation as a whole and that means protecting all of the stockholders, both poor and rich alike; and since, as the petitioners themselves assert, the vast majority of corporate stock is held by small

owners, it is inappropriate for the petitioners to accuse the Legislatures of New Jersey, New York, Pennsylvania, Maryland and Wisconsin of having the motive of protecting wealthy stockholders.

The petitioners might just as well argue that corporations should no longer be controlled by a majority of its stockholders, for certainly under that rule of law the large stockholders have more power than the small stockholders.

In the second place, it has been asserted that the classification is arbitrary because "whether a baseless derivative action be brought by a $10,000 stockholder in a $1,000,000 corporation, or by a $50,000 stockholder in a $5,000,000 corporation, the value of plaintiffs' stock would in each case be reduced by precisely the same amount * * *"; that the "motives of self-interest, counseling against the institution of the action, would thus in both cases have precisely the same weight."; and that "the plaintiff in the first case would, under the statute, have to give security, while the plaintiff in the second case would be exempt."

The one circumstance alleged in the one particular instance referred to results, of course, from permitting a derivative action to be prosecuted without restriction by the holders of stock having a value of $50,000 *or* representing 5% of the stock, whichever is easier to comply with. As in every conceivable classification, a borderline example may be found where no substantial difference will exist in some particular respect. But the question is whether the overall objectives have a reasonable relation to the evil found to exist. As shown above, in providing for these alternative ways of qualifying, the statute made an allowance for the practical situation that a stockholder in the larger corporation, with its stock more widely distributed in small holdings, will probably have more difficulty in enlisting the support of the same percentage of stock-

holders than a stockholder in the smaller, more closely held, corporation. Moreover, as will be shown immediately below, even a single stockholder with a $50,000 investment has a greater interest in the financial well-being of a corporation than a single stockholder with a $10,000 investment.

In the third place, it has been argued, in a vein similar to the argument referred to above, that if an action were brought by a $50,000 stockholder, the decrease in the book value of his stock threatened by the corporation's prospective litigation expenses would amount to a "paltry sum" which could not possibly operate as a deterrent discouraging a large stockholder from instituting a baseless derivative action.

This argument again seizes upon one factor (which is obviously insignificant) and overlooks all the other factors which are very significant. The economic interest which restrains a "large" stockholder from involving his corporation in groundless litigation is something more than his proportionate share of the expenses of litigation. He has a real stake in the financial well being of the company. The necessity to pay $100,000 of litigation expenses may in a given case weaken the cash position of a corporation and injure its business activities. He is interested in the zeal and competency of its management. The necessity of the executives of the company to be subjected to long examinations before trial interferes with their attention to business affairs. Charges made against corporation executives of fraud and misappropriation of assets (which appear in practically every derivative suit) may injure the corporation's reputation and business.

Further, persons who desire to participate in strike litigation would not be averse to "investing" $100 in several corporations but the necessity to invest $50,000 in several

corporations for such a purpose would certainly be a restraining influence. It has been recognized both by legislatures and by court rules that buying into strike litigation has been a real evil; and derivative actions have been forbidden by a stockholder who had purchased his stock after the alleged cause of action accrued. However salutary that restriction may be, it has not eliminated the opportunity for the kind of abuse referred to above. If a person intends to participate in the prosecution of *strike* litigation, his groundless allegations can be directed to any period of time.

Finally, this argument assumes that qualifying through the ownership of $50,000 of stock is a privilege which the statute confers on a *single* stockholder owning that amount of stock. It entirely overlooks that this provision of the statute permits any number of small stockholders to combine together to meet this qualification. As we have pointed out above, this provision of the statute enables small stockholders to prosecute a derivative action on the basis of progressively smaller percentages of the total stock of a corporation as the corporation gets larger. It is difficult to see why the petitioners protest as unreasonable a provision in the statute which would reduce the requirement that a small stockholder enlist the support of 5% of the stockholders to as low as, for example, 1/10 of 1% in the case of the $50,000,000 corporation.

All of the arguments which petitioners make against the classification which was adopted by the New Jersey Legislature are matters for legislative and not judicial consideration. All of the factors that they refer to and all of the factors we refer to, and still other factors, are matters to be weighed in the balance by the Legislature. They go to the wisdom of the classification. Maybe it can

be improved. But so far as we can see the Legislature did a good job with a difficult problem. And in any event it cannot justifiably be claimed that the classification which it adopted had no reasonable relation to the elimination of the evil with which it was concerned.

Finally, it should be pointed out that the very kind of classification here involved has been widely adopted in fixing the rights of stockholders.

The Trust Indenture Act of 1939 makes provision in section 315(e) (15 U. S. C. § 77ooo(e)), for the inclusion in a qualified trust indenture of a requirement for an undertaking for costs, including reasonable attorneys' fees. However, the section expressly provides that its provisions shall not apply "to any suit instituted * * * by any indenture security holder, or group of indenture security holders, holding in the aggregate more than 10 per centum in principal amount of the indenture securities outstanding, * * *"

Numerous state statutes require minimum percentage qualifications of stockholders before rights accrue or action can be taken, such as

(1) California—Corporations Code, Section 811 requires that a suit for the removal of a director for dishonesty or gross abuse of authority be brought by at least 10% of the stockholders.

(2) California — Corporations Code, Section 4600 requires action for voluntary dissolution to be brought by holders of not less than 50% of the outstanding stock.

(3) California—Corporations Code, Section 3095 provides that the Superior Court may enforce the right of inspection of corporate books and records on the application of 10% of the stockholders and also requires that the expense of such inspection or in-

vestigation be paid by the applicant unless the court orders them to be paid or shared by the corporation. Section 3011 provides that the shareholders holding at least 10% of the stock may make written request to the Secretary or Treasurer for a statement of its affairs where no statement is given to shareholders for the preceding six months.

(4) Connecticut—Gen. Stat. (1949) § 5226 requires 10% of the stockholders for petition for involuntary dissolution even though action is based on fraud, collusion or gross mismanagement.

(5) New Jersey—R. S. 14:14-3 gives stockholders owning 10% of stock the right to petition for a receiver of an allegedly insolvent corporation.

(6) New York—Stock Corporation Law, §§ 10 and 113 limit the right of inspection of stock books to stockholders of record for at least six months or those holding or authorized by 5% of the outstanding shares (§ 115 provides similarly as to voting trust certificates).

(7) New York—Stock Corporation Law, § 77 gives stockholders owning 3% of the shares of a corporation the right to request a statement of its affairs.

(8) Pennsylvania—Statutes Annotated (Purdon), Title 15 § 2852-405 (C) authorizes the removal of directors for fraud or abuse of authority upon the petition of holders of 10% or more of the stock.

(9) Virginia Code (1936) § 3810(b) limits suit for dissolution of a corporation to holders of at least 25% of stock.

C.

**The Application of the Statute to Actions Pending at the Time of its Enactment Does Not Violate the Due Process or Contract Clause.**

The petitioners contend that even if the statute is not otherwise unconstitutional, in any event its application to actions pending at the time of its enactment violates the due process and contract clauses of the Constitution. There is also no merit to this contention.

It should be noted at the outset that it is only in a very limited sense that this statute has any retroactive application. It is not retroactive in the sense that it imposes a liability on a person for acts performed in the past or that it restricts or impairs any property rights by reason of acts performed in the past. It merely imposes conditions on instituting or proceeding with the prosecution of an action in the courts of New Jersey and, as shown above, these conditions are not arbitrary or unreasonable in the light of a public evil found to exist.

Thus, the substantial effect of the statute is prospective rather than retroactive in its application. The evil found to exist relates not to the mere act of *instituting* a derivative action but to the continuing process involved in its *prosecution*. The loss and damage which the statute is designed to prevent will be caused by acts performed after the enactment of the statute, that is, the continued prosecution of the action.

In any event, it is settled beyond doubt that the mere fact that a statute is retroactive does not make it unconstitutional. This Court so held in *Blount* v. *Windley*, 95 U. S. 173, 180 (1877). The rule is stated as follows in the recent

case of *Fisch* v. *General Motors Corp.*, 169 F. 2d 266, 271 (6th Cir. 1948), cert. denied 335 U. S. 902 (1949):

> "... retroactive laws are not prohibited by the Constitution in civil cases. We have no power to declare them void upon that ground alone. Blount *v.* Windley, 95 U. S. 173, 180; Watson *v.* Mercer, 33 U. S. 56, 70."

Thus, the "retroactive" effect does not render an otherwise constitutional statute unconstitutional. The petitioners must show an unreasonable deprivation of their property in order to render the application of the statute to them unconstitutional. We have already shown *supra* under Point A, 2, that there is no basis for such a showing, and petitioners' arguments under this point are likewise insufficient to meet that test.

Petitioners state on page 33 of their brief that "as a result of the serious constitutional questions which would otherwise have arisen, the New York courts construed Section 61-b as being prospective in operation only." This is not a correct statement of the law of New York. In the first place, while the Court of Appeals has held that as a matter of statutory construction the statute was not intended to apply to actions pending at the time of its enactment, this was neither in whole nor in part based on constitutional grounds. Indeed, the Appellate Division, First Department, has expressly held that the statute could constitutionally be applied to pending actions.

> *Shickrawi* v. *Moffett*, 268 App. Div. 352, 51 N. Y. S. 2d 188 (1st Dep't 1944), aff'g 49 N. Y. S. 2d 64 (Sup. Ct., N. Y. Co., 1944), rev'd on other grounds 294 N. Y. 180, 61 N. E. 2d 435 (1945);

*Coane* v. *American Distilling Co.*, 270 App. Div. 1001, 63 N. Y. S. 2d 829 (1st Dept. 1946), aff'g 182 Misc. 926, 49 N. Y. S. 2d 838 (Sup. Ct. N. Y. Co., 1944), rev'd on other grounds 298 N. Y. 197, 81 N. E. 2d 87 (1948);

*Burnham* v. *Brush*, 78 N. Y. S. 2d 562 (App. Div., 1st Dep't 1948).

These holdings still stand, since the Court of Appeals did not have occasion to pass on the question.

In the second place, the constitutionality of the retroactive application of the statute to stockholders who had acquired their shares prior to its enactment and to causes of action which had accrued prior thereto has been upheld by the New York Court of Appeals in *Myer* v. *Myer*, 296 N. Y. 979, 73 N. E. 2d 562 (1947), aff'g 271 App. Div. 465, 66 N. Y. S. 2d 83 (1st Dep't 1946). The record in *Lapchak* v. *Baker, supra,* also shows that there the New York Court of Appeals upheld the constitutionality of the statute as applied to a plaintiff who became a stockholder in 1938 and to a cause of action which accrued in 1942, both several years prior to its enactment.

If it is constitutional to apply the statute retroactively to stockholders who acquired their shares prior to its enactment and to causes of action accrued prior thereto, it is immaterial whether or not suit was pending at that time. Rights otherwise subject to modification do not acquire a constitutional immunity merely because suits for their enforcement are begun. There is nothing sacrosanct about the institution of an action. There is no distinction between the rights of a stockholder in a pending action and those prior to its institution. In both cases, the alleged property right of a stockholder is exactly the same, namely, his alleged right to prosecute a derivative action. The

nature of this right is exactly the same before and after a complaint is filed. Thus, the question of the statute's application to pending action is merely one of legislative intent, and the Legislature of New Jersey has clearly expressed its intent on the point.

It follows that petitioners' position must rest on the proposition that the statute may not constitutionally be applied to stockholders who became such, and to causes of action which accrued, prior to its enactment. It is submitted that merely to state the proposition is to refute it. If the statute could not be applied to anyone who became a stockholder prior to 1945, it could be rendered ineffective for many years to come. The Legislature having found that an evil existed now, it surely had the power to provide a remedy effective now, rather than in the distant future. It was no more than reasonable for the Legislature to make the statute retroactive in that sense.

Petitioners assert that the statute here involved takes away every remedy for past wrongs. It is clear, however, that there is still an effective procedure to redress any past wrongs that the individual defendants may have committed against the corporation. Chapter 131 does not abolish any cause of action. The claims asserted against the individual defendants are not outlawed and can be asserted by any stockholder meeting the statutory requirements. The statute thus merely relates to the form of remedy and, as such, applies to pending actions.

Despite petitioners' assertion (on p. 34 of their brief) that the application of the statute not only to pre-existing causes of action but to pre-existing suits thereon makes this case unique, the fact is that in numerous cases statutes divesting causes of action involving even a plaintiff's *personal* rights have been held constitutional, as applied to

pending actions. In addition to the cases cited by the court below, reference is made to the recent cases upholding the application of the so-called Portal-to-Portal Act to suits pending at the time of its enactment.

*Battaglia* v. *General Motors Corp.*, 169 F. 2d 254 (2d Cir. 1948), cert. denied 335 U. S. 887 (1948);

*Darr* v. *Mutual Life Insurance Co.*, 169 F. 2d 262 (2d Cir. 1948), cert. denied 335 U. S. 871 (1948);

*Seese* v. *Bethlehem Steel Co.*, 168 F. 2d 58 (4th Cir. 1948);

*Atallah* v. *B. H. Hubbert & Son*, 168 F. 2d 993 (4th Cir. 1948), cert. denied 335 U. S. 868 (1948);

*Fisch* v. *General Motors Corp.*, 169 F. 2d 266 (6th Cir. 1948), cert. denied 335 U. S. 902 (1949);

*Rogers Cartage Co.* v. *Reynolds*, 166 F. 2d 317 (6th Cir. 1948).

In those cases, pending actions were dismissed in which the plaintiffs asserted their own rights to compensation valid and enforceable at the time the actions were commenced. *A fortiori*, it cannot violate the Constitution to apply Chapter 131 to a pending action where the cause of action does not belong to the plaintiff.

Petitioners further assert the application of Chapter 131 to a pending suit violates the contract clause of the Constitution. However, the conclusive answer to this contention is that the right to bring a derivative action is not a contract right. The right to bring a derivative action is merely a remedy created by the general common law applied

in equity courts. It is no more of a contract right than the right to get injunctive relief in certain situations or the right to have various common law writs issued or any of the other remedial process which have been adopted and changed from time to time.

Thus, it has been expressly held that the right to bring a derivative action does not fall within the protection of the contracts clause of the Constitution. In *Myer* v. *Myer*, 271 App. Div. 465, 474, 66 N. Y. S. 2d 83, 92 (1st Dept. 1946), aff'd 296 N. Y. 979, 73 N. E. 2d 562 (1947), the court, in upholding the constitutionality of the similar New York legislation, said:

> "The right [to bring a derivative action] is not so intimate in its relation to any contract rights of the stockholders as to be within the obligation of contract and thus immune from change."

However, even making the far-fetched assumption that a contractual right was involved, it is a principle of constitutional law that every contract is subject to the paramount police power of the State, and can be modified, burdened, and even abrogated, in the reasonable exercise of that power.

In *Home Building & Loan Association* v. *Blaisdell*, 290 U. S. 398, 434 (1934), Mr. Chief Justice Hughes, speaking for the Court, said:

> "Not only is the constitutional provision [of the contract clause] qualified by the measure of control which the State retains over remedial processes, but the State also continues to possess authority to safeguard the vital interests of its people. It does not matter that legislation appropriate to that end 'has the result of modifying or abrogating contracts already in effect.' *Stephenson* v. *Binford*, 287 U. S. 251, 276."

That Chapter 131 does not violate the contracts clause, follows *a fortiori* from the case of *Veix* v. *Sixth Ward Association*, 310 U. S. 32 (1940). In that case, the stockholder had purchased shares in a New Jersey building and loan association in 1928 and 1929. At that time the applicable New Jersey statutes provided *inter alia* that shares in such an association could be withdrawn by giving such written notice as the constitution or by-laws of the association provided, not to exceed 30 days, and that thereupon any member could recover the withdrawal value of his shares. A statute passed in 1932 provided among other things that so long as the funds of an association were applied as required by the 1932 statute, no member should have a right to recover the withdrawal value of his shares.

The plaintiff shareholder attacked the 1932 statute as violative of the contract clause. The New Jersey Court of Errors and Appeals upheld the constitutionality of the statute and this Court affirmed. This Court pointed out that the statute was passed in the public interest to protect the welfare of the associations and was a valid exercise of the police power. In holding that the statute did not violate the contract clause, the Court said (at p. 38):

> "This is so because the obligation of the Association to respond to the application for withdrawal was subject to the paramount police power."

In *Battaglia* v. *General Motors Corp., supra*, the application of the Portal-to-Portal Act to pending suits was upheld on similar grounds. The court said (169 F. (2d) at p. 260):

> "If the contractual arrangements of these private parties were subject to the Fair Labor Standards Act as it might be interpreted by the courts, or were modified to take into consideration decisions con-

> struing that statute, they were also subject to changes made in it by Congress in the exercise of its power to regulate commerce."

These cases clearly establish that in the exercise of the police power, personal contract rights may be validly modified and even abrogated. *A fortiori,* the instant statute cannot violate the contracts clause, since it merely modifies a remedy given for the protection, not of the stockholder's personal rights, but of the rights of the corporation.

Moreover, it has been repeatedly adjudicated by the New Jersey courts that the application to pre-existing contracts and actions of the very kind of statute here involved, that is, a statute creating a right to counsel fees, does not violate the contracts clause.

The leading case is *Igoe Bros.* v. *National Surety Co.,* 112 N. J. L. 243, 169 Atl. 841 (1934). There, the surety company had entered into a contract of suretyship with a contractor in 1930. On April 12, 1932, plaintiff instituted suit on the bond against the surety for a balance due from the contractor. On May 2, 1932, a statute became effective, which changed the previously applicable law by providing, *inter alia,* that

> "* * * upon the trial of any such action the court shall award to the prevailing party a reasonable attorney's fee to be taxed as costs, and to be included in the judgment therein rendered."

The surety resisted liability for the attorney's fee on the ground that to apply the statute would impair the obligation of its contract. However, the Court of Errors and Appeals held that the application of the statute did not violate the contract clause.

The same holding was made in *Savitt* v. *L. & F. Construction Co.*, 124 N. J. L. 173, 10 A. 2d 728 (1940); *Robinson* v. *Jackson*, 14 N. J. Misc. 866, 187 Atl. 918 (Ct. Com. Pleas, 1936); *Murphy* v. *Brown & Co.*, 91 N. J. L. 412, 103 Atl. 28 (Sup. Ct., 1918).

## D.

## Application of the Statute Does Not Violate the Full Faith and Credit Clause.

Petitioners contend that because the respondent is a Delaware corporation and the Delaware law does not require the posting of security, the application of the New Jersey statute violates the full faith and credit clause. It is clear, however, that the rule adopted by the New Jersey Legislature which makes the statute expressly applicable to suits instituted in the right of foreign as well as domestic corporations, does not violate the full faith and credit clause for the following reasons:

(1) The statute merely embodies a well established principle of conflict of laws.

(2) Even if the statute changed the common law of conflict of laws, New Jersey, by reason of its paramount governmental interest, had the power to do so.

(3) In any event, the full faith and credit clause has no application to the common law of a sister state.

### 1. The statute merely embodies a well established principle of conflict of laws.

Under established principles of conflict of laws, a statute which merely regulates, as does Chapter 131, the conditions on which an action may be prosecuted in the State's own courts, applies to all of such actions, whether foreign or

domestic. Without such a principle, there would be no uniformity with respect to the rules governing the prosecution of identical actions in the same court. The citizens of New Jersey would be subjected to gross discrimination. One citizen, owning stock in a domestic corporation, would be required to meet the conditions of the statute, and another citizen, owning stock in a foreign corporation would be exempt.

Thus it has long been the established rule that a State may apply its own statute of limitations to bar foreign causes of action asserted within its courts. The effect of such a statute is more restrictive than the conditions imposed by Chapter 131. The former statute completely bars the prosecution of an action. Chapter 131 merely requires that a plaintiff-stockholder either enlist the support of a very small percentage of the other stockholders, or else put up security, in an amount determined by the court to be reasonable.

This rule has been applied to the very statute here involved in *Shielcrawt* v. *Moffett*, 184 Misc. 1074, 56 N. Y. S. 2d 134 (Sup. Ct., N. Y. Co., 1945). This case squarely held that Chapter 131 was "procedural" for conflict of laws purposes, the same as statutes of limitations. The court said (184 Misc. at p. 1077, 56 N. Y. S. 2d at p. 136):

> "* * * it seems to me that a major concern is whether Section 61-b is procedural in the sense that it is the type of statute which our Courts may apply conveniently, practically and properly to foreign corporations doing business in this state to the end that our procedure shall maintain a desirable measure of uniformity in derivative stockholders' suits. I believe that Section 61-b, and it must therefore follow, its New Jersey counterpart, are procedural in that sense."

**2. Even if the statute changed the common law of conflict of laws, New Jersey, by reason of its paramount governmental interest, had the power to do so.**

The statute did not legislate with respect to the internal affairs of a foreign corporation or with respect to the rights or liabilities between stockholders, directors and officers and a foreign corporation in connection with its internal affairs. The statute merely imposes certain legal consequences *for acts in the courts of New Jersey,* in connection with the prosecution of a derivative action. The statute was designed to cope with abusive strike suits and to protect innocent parties to such actions from sustaining heavy losses resulting from acts performed within the State of New Jersey. The statute did not change rights or liabilities respecting the relationships outside the New Jersey courts.

New Jersey has the paramount interest of making its policy uniformly applicable to the same acts performed within its boundaries, whether on behalf of a foreign or domestic corporation; and of protecting persons brought into its courts against unreasonable loss resulting from irresponsible litigation.

Thus, New Jersey has a sufficient governmental interest to enforce the statute against all litigants in its courts under the very rule which the petitioners refer to in their brief (p. 31), laid down by this Court in *Alaska Packers Ass'n* v. *Industrial Accident Commission,* 294 U. S. 532 (1935), to the effect that conflicting state policies must be reconciled

> "* * * not by giving automatic effect to the full faith and credit clause, compelling the courts of each state to subordinate its own statutes to those of the other, but by appraising the governmental interests of each jurisdiction, and turning the scale of decision according to their weight."

Manifestly, Delaware has no governmental interest at all with respect to the conditions under which actions may be prosecuted in New Jersey courts.

The courts of New York have consistently applied the similar New York statute to derivative suits brought on behalf of foreign corporations.

Moreover, it is well established that a state has a governmental interest with respect to acts performed by, or on behalf of, a foreign corporation within its boundaries, and especially in creating uniformity with domestic corporations. That is precisely what the statute here involved does. New Jersey's power to do so cannot be questioned. Thus, it was stated in *New York Life Insurance Co.* v. *Cravens*, 178 U. S. 389, 401 (1900):

> "The power of a State over foreign corporations is not less than the power of a State over domestic corporations. No case declares otherwise. We said in *Orient Ins. Co.* v. *Daggs, supra*: 'That which a State may do with corporations of its own creation it may do with foreign corporations admitted into the State. * * * The power of a State to impose conditions upon foreign corporations is certainly as extensive as the power over domestic corporations * * *.'"

Accord:

> *Osborn* v. *Ozlin*, 310 U. S. 53 (1940);
> *Hoopeston Co.* v. *Cullen*, 318 U. S. 313 (1943).

In the *Hoopeston Co.* case, this Court said (at p. 320):

> "Nothing in the Constitution requires a state to nullify its own protective standards because an enterprise regulated has its headquarters elsewhere. * * * Where as here the state has full power to prescribe the forms of contract, the terms of protec-

> tion of the insured, and the type of reserve funds needed, 'the mere fact that state action may have repercussions beyond state lines is of no judicial significance.' *Osborn* v. *Ozlin, supra,* at 62."

The case of *Broderick* v. *Rosner,* 294 U. S. 629 (1935), relied on by the petitioners, is inapplicable to the instant case. In that case, New Jersey attempted to prevent foreign corporations from enforcing against its citizens an obligation to pay assessments voluntarily assumed by them under the laws of the state of incorporation, while at the same time permitting actions to recover assessments made by domestic corporations. Thus, New Jersey had no public policy against actions of that nature; and manifestly it had no legitimate *governmental* interest at all in helping individuals to escape from the payment of a just obligation.

**3. Finally, in no event does the full faith and credit clause have any application to this case.**

Article IV, Section 1 of the Constitution provides as follows:

> "Full faith and credit shall be given in each State to the public Acts, Records, and Judicial Proceedings of every other State. And the Congress may by general Laws prescribe the Manner in which such Acts, Records and Proceedings shall be proved, and the Effect thereof."

This provision does not embrace common law, as distinguished from the statutes of a sister State. None of the words, "public Acts," "Records" or "Judicial Proceedings" embrace unwritten law. Moreover, in conferring power on the Congress to prescribe the manner in which such acts, records and judicial proceedings shall be *proved,*

it was made clear that the clause was not applicable to the common law of a sister State.

As elsewhere, the remedy of derivative stockholder's suits in Delaware was not created by statute, but was developed in the courts of equity. If in Delaware a plaintiff-stockholder need not give security out of which the corporation may seek reimbursement, this is so because of the failure of the *common* law of Delaware to set up such requirement. There is no Delaware statute on the point.

This Court has never held that the full faith and credit clause may compel a state to apply the common law of another state. Petitioners' assertion to the contrary on p. 31 of their brief is incorrect. *Aetna Life Insurance Co.* v. *Dunken*, 266 U. S. 389 (1924), involved the question whether Texas had to give full faith and credit to a Tennessee *statute*, 1917 Tenn. Code §3369a 141. In *Order of United Commercial Travelers* v. *Wolfe*, 331 U. S. 586 (1947), the Court was careful to point out the public acts of Ohio to which full faith and credit had to be given (pp. 591-592).

Petitioners' attempt to transform the question into one of statutory law by referring to Delaware's reception statute enacted in 1776 (note 12, p. 30 of their brief) is unworthy of consideration. According to their own statements on p. 18 of their brief, stockholders' derivative suits were not known in 1776.

Even if there were a Delaware statute on the point, there would be no conflict with Chapter 131, and hence the full faith and credit clause would not be applicable. For a Delaware statute regulating the prosecution of derivative actions in its courts would not even purport to apply to actions in the courts of New Jersey.

As would be expected from the well established principles referred to above, the courts of New York have consistently applied the similar New York statute to derivative suits brought on behalf of foreign corporations. The argument of the petitioners here is an almost exact copy of the argument submitted to the New York Court of Appeals in *Lapchak* v. *Baker, supra,* which was also a suit brought in the right of a Delaware corporation. As already pointed out, the Court of Appeals rejected this argument and held that the statute could constitutionally be applied in such case.

## CONCLUSION.

**The judgment of the Court of Appeals for the Third Circuit should be affirmed in all respects.**

Respectfully submitted,

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## Appendix A.

### Statutes and Rules Involved.

Chapter 131 of the New Jersey Laws of 1945 (R. S. Cum. Supp. 1945/1947, 14:3-15, 14:3-17), insofar as here applicable, has been set forth *supra*, on pages 2-3.

28 U. S. C. §1291 provides as follows:

> "The courts of appeals shall have jurisdiction of appeals from all final decisions of the district courts of the United States, the District Court for the Territory of Alaska, the United States District Court for the District of the Canal Zone, and the District Court of the Virgin Islands, except where a direct review may be had in the Supreme Court."

28 U. S. C. §1651(a) provides as follows:

> "The Supreme Court and all courts established by Act of Congress may issue all writs necessary or appropriate in aid of their respective jurisdictions agreeable to the usages and principles of law."

28 U. S. C. §1652 provides as follows:

> "The laws of the several states, except where the Constitution or treaties of the United States or Acts of Congress otherwise require or provide, shall be regarded as rules of decision in civil actions in the courts of the United States, in cases where they apply."

Rule 23 of the Federal Rules of Civil Procedure provides as follows:

"(b) *Secondary Action by Shareholders.* In an action brought to enforce a secondary right on the part of one or more shareholders in an association, incorporated or unincorporated, because the association refuses to enforce rights which may properly be asserted by it, the complaint shall be verified by oath and shall aver (1) that the plaintiff was a shareholder at the time of the transaction of which he complains or that his share thereafter devolved on him by operation of law and (2) that the action is not a collusive one to confer on a court of the United States jurisdiction of any action of which it would not otherwise have jurisdiction. The complaint shall also set forth with particularity the efforts of the plaintiff to secure from the managing directors or trustees and, if necessary, from the shareholders such action as he desires, and the reason for his failure to obtain such action or the reasons for not making such effort.

(c) *Dismissal or Compromise.* A class action shall not be dismissed or compromised without the approval of the court. If the right sought to be enforced is one defined in paragraph (1) of subdivision (a) of this rule notice of the proposed dismissal or compromise shall be given to all members of the class in such manner as the court directs. If the right is one defined in paragraphs (2) or (3) of subdivision (a) notice shall be given only if the court requires it."

Rule 15 of the General Rules of the District Court of the United States for the District of New Jersey provides as follows:

"*Applicability of State Court Procedure.* In circumstances not provided for by the Federal Rules of Civil Procedure, or by these rules, the procedure and practice of the Courts of the State of New Jersey shall govern."

le 45 of the Civil Rules of the United States District
urt for the Eastern District of New York provides as
ows:

"*Procedure in Absence of Rule.* Whenever a procedural question arises which is not covered by the provisions of any statute of the United States, or of the Federal Rules of Civil Procedure, or of these rules, it shall be determined, if possible, by the parallels or analogies furnished by such statutes and rules. If, however, no such parallels or analogies exist, then the procedure heretofore prevailing in courts of equity of the United States, or in default thereof the procedure which shall then prevail in the Supreme Court of the State of New York shall be applied."